IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-242

THE FRANKLIN LIFE INSURANCE COMPANY, a corporation, individually and representatively on behalf of all holders of the 9.44% Cumulative Prior Preferred Stock of Commonwealth Edison Company, a corporation,
Petitioners,

v.

COMMONWEALTH EDISON COMPANY, a corporation,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioner, The Franklin Life Insurance Company, et al., prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit entered on May 22, 1979.

OPINIONS BELOW

The Opinion of the Court of Appeals affirming the decision of the District Court and adopting its Memorandum Order as the opinion of the Court of Appeals, with an exception not here germane, is reported at 598 F.2d 1109 and is reprinted as

Appendix A hereto (App. p. A-1, *infra*). The Memorandum Order of the District Court is reported at 451 F.Supp. 602 (S. D. Ill. 1978) and is reprinted as Appendix D hereto (App. p. A-6-A-32, *infra*).

JURISDICTION

The judgment of the Court of Appeals was entered on May 22, 1979 (Appendix B, p. A-3, *infra*). A timely Petition for Rehearing was denied on June 22, 1979 and a corrected order of denial was entered June 27, 1979 (Appendix C, p. A-5, *infra*). The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

(1) When the issuer of a high yield security (9.44% Preferred Stock) states in its prospectus that the security may not be "redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt" at an interest cost below 9.44%, is it liable (under the Federal Securities Laws) to buyers for failing to disclose in the prospectus:

(a) It believed it could redeem the security from the proceeds of common stock even though it may be borrowing heavily, before and after the redemption, at rates far below 9.44%, and

(b) Its plans and considerations with respect to early redemption?

(2) When the prospectus and the terms of a high yield security (9.44% Preferred Stock) prohibit redemption "through refunding, directly or indirectly, by or in anticipation of the incurring of any debt" at an interest cost below 9.44%, does the issuer breach its contract with the holders of the security

by redeeming the security from the proceeds of an issue of common stock sandwiched between the incurring of hundreds of millions of dollars of debt at interest costs far below 9.44%?

(3) Is the issuer of securities listed on the New York Stock Exchange required to comply strictly with the requirements for giving notice of the taking of corporate action looking toward the redemption of securities?

(4) Is the redemption of securities in violation of the terms of the prospectus offering the securities and in violation of the contractual responsibilities of the issuer-seller respecting the securities also a violation of the fraud provisions of the Federal Securities Laws?

STATUTES AND RULE INVOLVED

Sections 11(a) and 17(a) of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §77k and 77q, Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. §§ 78j(b) and Rule 10b-5, 17 C.F.R., Section 240. 10b-5 are set forth as Appendix E hereto (App. p. A-33, *infra*).

STATEMENT OF THE CASE

Petitioner, The Franklin Life Insurance Company, filed this action individually and as representative of the class of persons holding shares of 9.44% Cumulative Prior Preferred Stock ("STOCK") issued by Commonwealth Edison Co. ("EDISON"). Other class members, including Teachers Retirement System of Texas ("Texas Teachers") were granted leave to intervene or entered their appearance through various counsel. The action was certified as a class action under Federal Rules of Civil Procedure 23(b)(3). Petitioners alleged violation of §§ 11 and 17 of the Securities Act of 1933, 15 U.S.C. § 77k,

and 15 U.S.C. § 77q respectively, as well as Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

The Stock Issuance

On June 24, 1970 Commonwealth Edison Company, Respondent, through underwriters, publicly sold one million shares of its 9.44% Cumulative Prior Preferred Stock ("STOCK") at a price of $100 per share pursuant to a registration statement filed with the Securities and Exchange Commission ("SEC") effective June 24, 1970. At the time the STOCK was issued investment funds were in short supply and as a result preferred stock issues bore an uncharacteristically high rate of return. Although EDISON would have preferred to issue the STOCK with a dividend rate of 9.25% and a five year redemption restriction, it was convinced by its underwriters, primarily the First Boston Corporation, that a dividend rate of 9.44% and a ten year redemption restriction were required for a successful stock issue (App. p. A-8, *infra*). The Petitioner and an intervening plaintiff, Texas Teachers, invested $2.5 million and $3 million (respectively) in the STOCK as a long term investment.

The STOCK was redeemed March 20, 1972 at $110 a share when interest rates had dropped below 7.5%. Before the redemption announcement, the STOCK was trading on the New York Stock Exchange at prices around $120 a share.

A prospectus was filed with the SEC and distributed to investors for the original sale of the STOCK. The prospectus stated on page 1 that the STOCK was:

> "(n)ot redeemable, directly or indirectly, prior to August 1, 1980, through certain refunding operations (See page 2)."

On page 2 of the prospectus, the text of the redemption provision provided:

> "(p)rior to August 1, 1980, *none* of the shares of the 9.44% Prior Preferred Stock may be *redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt or the issuance of any shares of the Prior Preferred Stock or any other stock ranking on a parity with the Prior Preferred Stock, if such debt has an interest cost to the Company (as defined), or such shares have a dividend cost to the Company (as defined), less than the dividend cost to the Company of the 9.44% Prior Preferred Stock*. Subject to the foregoing, the 9.44% Prior Preferred Stock will be redeemable at the option of the Company as a whole at any time or in part from time to time at the following per share redemption prices: $110 if redeemed before August 1, 1980; $107 if redeemed on or after August 1, 1980, but before August 1, 1983; $104 if redeemed on or after August 1, 1983, but before August 1, 1986; and $101 if redeemed on or after August 1, 1986; in each case plus accrued and unpaid dividends, if any. (Italics added.)

The prospectus also contained a section entitled "Purpose of Issue and Construction Program" on pages 4 and 5. This section stated that the proceeds from the sale of the STOCK would be added to working capital for application partly toward payment of commercial short term paper and partly for interim financing of the construction program. The section described the construction program for the next five year period, 1970-1974, "as now forecast, calls for electric plant expenditures of approximately $2,250,000,000." Of that amount it was estimated that $1,150,000,000 would have to be raised through the sale of additional securities. (App. p. A-9 *infra*)

Consistent with this construction program, EDISON's long term debt increased from $1.849 Billion at the end of 1971 to an amount in excess of $3 Billion at the time of the trial of the issues in 1977. Each issue of long term debt made by EDI-

SON subsequent to 1971 was at an interest cost to EDISON of less than 9.44%. During 1972 EDISON also incurred debt through the issuance of short term promissory notes. Its short term debt on January 1, 1972 was $140,000,000 and at the end of 1972 it was $258,000,000. All of the short term debt was at an interest rate of less than 9.44% (App. p. A-9, *infra*).

At the time the STOCK was offered to the public on June 24, 1970, EDISON considered redemption of the STOCK when market conditions were feasible to do so and it was advantageous to its other stockholders as a viable alternative to the payment of the high dividend rate. EDISON also believed that it could redeem the STOCK at any time from the proceeds of common stock and warrants and its belief was not affected by the fact that it needed more than $1 Billion of outside financing the five year period next after the issuance of the STOCK. This information was not disclosed in the prospectus although EDISON knew it would have influenced the judgment of investors if it had been disclosed (Tr. 385-387, App. 123-125).

The Petitioner read and relied on the prospectus as a whole in making its decision to purchase the STOCK and believed from the prospectus that EDISON would be a net borrower . . . to meet its construction needs . . . for at least five years after the issuance of the STOCK . . . EDISON would be increasing the amount of its debt each year and Petitioner was led to believe the STOCK could not be redeemed while EDISON was anticipating borrowing at a lesser interest cost than 9.44%. Had Petitioner believed otherwise it would not have purchased the STOCK as its investment philosophy called for long term investments to honor obligations to its policyholders, annuitants and retirees which would continually mature over long periods of time. Analysts and brokers had a similar belief and would not, had they believed otherwise, recommended that their clients or customers purchase the STOCK. Other individual investors relying

upon the prospectus, summaries contained in Standard & Poor's and stock brokers' understanding of the redemption provisions, purchased the STOCK with the common understanding they would be able to own the STOCK until August 1, 1980 (Pl. Exs. 92-95, 97-121).

Had EDISON inserted in its prospectus its belief that it could redeem the STOCK at any time from the proceeds of an issue of common stock and planned to do so when market conditions made it feasible, neither Petitioner nor intervening plaintiff, Texas Teachers, would have purchased the STOCK.

From the time of the issuance of the STOCK in June 1970 until its redemption was announced on January 4, 1972, the STOCK traded on the New York, Midwest and Pacific Stock Exchanges. Throughout 1971 it traded above $110 per share (the redemption price) and was trading at $119.6875 per share on January 4, 1972, the date EDISON announced its proposed redemption of the STOCK. The following day the price of the STOCK fell to $111.375 per share for an overnight loss of $8.3125 per share . . . a total market loss of $8,312,500.

The Trial Court found that the omissions charged against EDISON were material and that reliance is to be presumed as the testimony established that had plaintiffs known either of an intent to redeem when market conditions made it feasible or of EDISON's belief that redemption could be accomplished out of the issuance of common stock prior to August 1, 1980 without regard to borrowings at a lesser interest cost than the 9.44% dividend rate on the STOCK, they would not have purchased (App. p. A-15, *infra*). The Trial Court observed that the material facts assertedly omitted are not objective but are subjective. The Trial Court observed that the Plaintiffs would require statements of EDISON's intent and of EDISON's belief concerning the proper interpretation of the redemption provisions of the prospectus. The Trial Court stated that whether the securities

laws are broad enough to require disclosure of such facts is open to serious question. Whether the prospectus adequately disclosed these facts is another question on which the Trial Court expresses no opinion (App. p. A-16, *infra*). The Trial Court in ruling against the Petitioner did so upon the basis of a failure to show scienter on the part of EDISON.

From the time of the issuance of the STOCK in June 1970 until its redemption was announced on January 4, 1972 and completed on March 20, 1972, the STOCK traded on the New York, Midwest and Pacific Stock Exchanges. The agreement for listing the STOCK on the New York Stock Exchange required the publication of any action taken by EDISON with respect to rights or benefits pertaining to the ownership of the STOCK, and Section A10 of the New York Stock Exchange Manual defines publicity in the listing agreement in respect of redemption action and requires a news release to be made as soon as possible after corporation action which will lead to or looks toward redemption. The agreement provides that to insure coverage the news should be released to one or more newspapers of general circulation in New York City which regularly publish financial news or to one or more wire services.

The Stock Redemption

By proxy statement dated February 25, 1971 for EDISON's annual meeting to be held on April 2, 1971, EDISON announced a proposed amendment to its Articles of Incorporation to increase the number of shares of authorized common stock and stated that it anticipated that new preference or additional common stock may be sold to redeem or otherwise be used to retire all or part of the STOCK but that EDISON had no definitive plans. At the annual meeting on April 2, 1971, when the stockholders approved the increase and authorization of stock of EDISON, thereby making it possible for EDISON to issue common stock for more than enough money to retire the entire

issue of STOCK, EDISON announced that it was disappointed in the 9.44% dividend rate on the STOCK and that it expected to refund it when market conditions made it feasible to do so. EDISON did not comply with its agreement with the New York Stock Exchange. It did make a wide distribution of the proxy statement with information respecting the redemption set forth in five lines on page 6 of a 28-page proxy statement. It distributed to the press and brokerage firms Notes to its Annual Meeting held on April 2, and reference to the redemption was set forth in three lines on page 5 of a 15-page summary of the meeting. EDISON was well aware that the investment community was not alerted to the possibility of redemption as it monitored the trading on the New York Stock Exchange as reported daily in the Wall Street Journal. From the annual meeting date on April 2, 1971 until the redemption was announced by a news release appearing in the Wall Street Journal on January 5, 1972, 147,300 shares of the STOCK were traded on the New York Stock Exchange for an average of $7.18 per share above the $110 redemption price.

Following the announcement of the proposed redemption on January 5, 1972, EDISON received numerous protests from its shareholders and complaints that it had no right to make such redemption but redeemed despite protesting delegations from leading utilities analysts. In the prospectus dated February 22, 1972 for the units of common stock with warrants used for the redemption, and prior to the redemption, EDISON acknowledged receipt of communications from shareholders protesting redemption, claiming the prospectus for the STOCK did not clearly indicate there could be a redemption prior to August 1, 1980 and claiming that Edison could not redeem because it was continuing to use debt as part of a continuing program to finance construction which might have a lower cost than the 9.44% dividend on the STOCK. Despite these protests and claims of rights, EDISON proceeded with redemption thereby depriving the owners of the STOCK of their rights of ownership.

In addition to the actions based on the violation of the Federal Securities Laws and the New York Stock Exchange agreements, Petitioners claim a breach of contract as the terms of the STOCK and the provisions in EDISON's Articles of Incorporation respecting the same constituted a contract between the stockholders and EDISON. The Petitioners asserted that the contract did not permit redemption at the time EDISON was in the process of borrowing money at an interest cost less than the 9.44% dividend on the STOCK. The District Court in deciding against Petitioners on this issue stated in its Memorandum Order:

> "The actions of EDISON as shown by the evidence, could be characterized as redemption in anticipation of debt since it well knew its financing needs and that in the current market those needs could be met at a cost of less than 9.44%. If the redemption clause requires an examination of the entire borrowing activities of EDISON then plaintiffs should prevail.
>
> "However, I believe that the clause forbidding redemption through refunding by or in anticipation of debt, requires an examination of only the source of the funds actually used to achieve the redemption. Were the proceeds of the issue of common stock and warrants in anticipation of debt at an interest cost of less than 9.44%? The answer must be no. Common stock cannot be refunded." (App. p. A-27, *infra*)

The trial Court concluded:

> "Although I believe EDISON could have avoided this entire matter by making its right express, I cannot say that EDISON's drafting, which stated expressly the methods by which redemption was prohibited and impliedly reserved to itself all other methods, violated the Federal Securities

> Laws or violated plaintiffs' vested contract rights. The decision here has not been quick nor easy. Drafting could have alleviated not only the time and effort spent here but the unrewarded expectations of plaintiffs." (App. p. A-32, *infra*)

The Trial Court gave judgment for EDISON. The Court of Appeals affirmed per curiam, adopting the Trial Court's Memorandum Order (with an exception not relevant here).

REASONS FOR GRANTING THE WRIT

The reasons for granting the writ are legal and economic. The legal reasons are detailed below. The economic reasons, although vastly important, will not be elaborated. In brief, they are that billions of dollars of redeemable securities play a critical role in financing business on the one hand and providing investment opportunities on the other. During 1978 there were public and private offerings of approximately $50 Billion of bonds and preferred stocks and many of these issues of securities have redemption terms similar to the redemption terms at issue in this action. In excess of $12 Billion of these securities were issued by public utilities. The yields on 1978 public offerings of these securities range from an approximate 10.25% to 8.40%. With stable interest rates apparently a thing of the past, redemption provisions assume overpowering importance. For redemption has the ability to let issuers refinance their high interest obligations more cheaply when rates decline and, at the same time, deprive investors of their high rate of return. Issuers and investors alike are entitled to clarification of what disclosure must be made about redemption terms, what the boilerplate redemption language means, and how redemption may be carried out. The issues are particularly timely since we appear to be moving into another decline of interest rates from a very high level . . . precisely the situation which led to the redemption in this case. Moreover, the decision in this case may possibly affect the rights of issuers and holders of billions of dollars of securities owned by the investing public.

Turning to the legal reasons, the Court of Appeals (by adopting the District Court Memorandum Order) has decided important issues of Federal Securities Law which have not been but should be settled by this Court. These center on (1) the disclosure obligations in a 1933 Act prospectus and the use there of misleading language (which is defended on the ground that

it is boilerplate but which was never used for redemption by anyone except EDISON), (2) the proper standard of scienter when a 1934 Act Rule 10b-5 claim is based on a 1933 Act registration statement, and (3) the application of the antifraud provisions to a redemption of securities.

The District Court, in its Memorandum Order, recites a finding of undisputed testimony that the omissions charged were material and that reliance is to be presumed and that had plaintiffs known either of EDISON's intent to redeem when market conditions made it feasible to do so or of EDISON's belief that redemption could be accomplished out of an issue of common stock prior to August 1, 1980 without regard to the debt being incurred it would not have purchased the STOCK. The District Court declared that the material facts assertedly omitted are not objective but are subjective and declined to rule on whether the securities laws are broad enough to require the disclosure of subjective facts and, moreover, expressed no opinion on whether the prospectus adequately disclosed these facts. (App. p. A-16, *infra*) The Court of Appeals, in adopting the Memorandum Order, similarly expresses no opinion on this most significant issue, which not only relates to the claims of the plaintiffs but to the problems to be faced by investors when interest rates decline in the future. The decision undermines the intent or recklessness standard earlier created.

SUMMARY OF ARGUMENT

1. EDISON violated the disclosure requirements of the Federal Securities Laws in the 9.44% Preferred Stock Prospectus
   1.1 The Securities Laws are intended to obtain full disclosure to and fair treatment of investors.

   1.2 EDISON did not adequately disclose the redemption terms of the STOCK, and the statements it made were materially misleading

   1.3 EDISON's misrepresentations and omissions were with scienter

   (A) The standard is recklessness

   (B) Great care is required in a $100 Million stock offering

   (C) Great care is required when there is a conflict of interest

   (D) Great care was taken in preparing the construction and financing forecast, and no less care is required in the closely related redemption terms

   (E) EDISON acted recklessly in writing the redemption terms of the prospectus

2. EDISON's redemption of the 9.44% STOCK was "through refunding directly or indirectly, by or in anticipation of any debt" at a lower interest cost to EDISON than the $9,440,-000 annual dividend cost to EDISON on the 9.44% STOCK and the redemption breached the contract with owners of the STOCK

   2.1 The meaning of the redemption contract (and the consequent breach) are established as a matter of law and also by the evidence

   (A) The evidence shows breach

   (B) The redemption language does not support the Trial Court's holding that there was no breach

   2.2 If there is any doubt about the meaning of the contract, it should be construed strictly against EDISON on the principles of adhesion and contra proferentum

3. EDISON breached its contract with the New York Stock Exchange which was for the benefit of the holders of the STOCK

4. EDISON violated the fraud provisions of the Federal Securities Laws when it redeemed the STOCK

ARGUMENT

1. **EDISON Violated the Disclosure Requirements of the Federal Securities Laws in the 9.44% Preferred Stock Prospectus.**

   1.1 **The securities laws are intended to obtain full disclosure to and fair treatment of investors.**

The need for buyer information is at the heart of the Securities Act of 1933, which is often called the "Truth in Securities" Act. The thrust of the 1933 Act, particularly the registration and prospectus provisions, was emphasized very succinctly by the President when he sent the proposed Bill to Congress: "This proposal adds to the ancient rule of caveat emptor the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller." (Letter from President Franklin D. Roosevelt to Congress, Mar. 29, 1933.)

The broad purpose of the Federal Securities Laws has been stated time and again by the judiciary at all levels. In *Affiliated Ute Citizens v. U. S.*, 406 U.S. 128, 151 (1972), Mr. Justice Blackmun said it once more in speaking for a unanimous Supreme Court:

> "The Court has said that the 1934 Act and its companion legislative enactments (including the 1933 Act) embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.' *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186, 11 L.Ed.2d 237, 243, 84 S.Ct. 275 (1963). In the case just cited the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed *'not technically and restrictively, but flexibly to effectuate its remedial purposes'*. Id., at 195, 11 L.Ed.2d at 248. This was recently said once again in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12, 30 L.Ed.2d 128, 134, 92 S.Ct. 165 (1971)." (*Italics supplied.*)

Rule 10b-5, promulgated by the Securities and Exchange Commission under authority granted in 1934 Act §10(b), 15 U.S.C. §78j(b), is an important implementation of the full disclosure-fair treatment system. It provides:

> "[I]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of a national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the sale or purchase of any security." 17 CFR §240.10b-5.

Even when construing §10(b) and Rule 10b-5 narrowly, this Court has recognized that disclosure is the overriding purpose:

> ". . . [T]he Court repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute."

Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477-478 (1977) (by Mr. Justice White).

> "The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities . . ."

Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (by Mr. Justice Powell).

1.2 **EDISON did not adequately disclose the redemption terms of the STOCK, and the statements it made were materially misleading.**

In purported compliance with the full disclosure requirements of the 1933 and 1934 Acts EDISON's prospectus prominently stated (on page 2, cross referenced on the cover page) that the STOCK could not be "redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt" at an interest cost below 9.44%.

Placed as it was, and coming at a time of high interest rates, that language could only be construed as an assurance to investors that they would not be deprived of their high dividends by a redemption when interest rates dropped if EDISON was then in anticipation of borrowing. The meaning of the redemption language is discussed further in Part 2 below at p. 28.

The prospectus did not disclose—did not even hint at—the following interpretations and information, all of which EDISON concedes it held at the time the STOCK was sold:

(1) EDISON believed it could redeem the STOCK at any time from the proceeds of common stock and warrants (Tr. 429, 430; Stip. 7).

(2) Its belief was not affected by the fact that it had announced that it needed more than $1 Billion of outside financing in the next five years (Stip. 8) . . . in other words, it saw

no connection between (a) its construction and outside financing forecast and (b) the "anticipation" language in the redemption terms or, as an inevitable sequel, the "anticipation" language was meaningless in EDISON's interpretation.

(3) EDISON considered redemption of the STOCK when market conditions made it feasible as a strong possibility (Tr. 385).

(4) It considered redemption of the STOCK when market conditions made it advantageous to the EDISON common shareholders as a strong possibility (Tr. 386).

(5) It considered redemption of the STOCK when market conditions made it feasible and when it was good for the EDISON common shareholders as a viable alternative open to EDISON (Tr. 385).

This information was not disclosed although EDISON's Vice Chairman and Chief Financial Officer, Corey, conceded that it would have influenced the judgment of investors if it had been disclosed.

The Trial Court's characterization of the information concealed in the prospectus as not objective but subjective is beside the point when the information is required to be disclosed by Federal law, as redemption terms are. See SEC Form S-1, Item 13(a)(6), 2 CCH Fed. Sec. L. Rep. § 7123; SEC Form S-7, Item 7(a)(6), CCH ¶ 7192; and accompanying Instruction 1 to these Items: "a brief summary of the (redemption) provisions which are pertinent from an investment standpoint." See also SEC Sec. Act. Rule 408, 17 C.F.R. § 230.408, which . . . with reference to registration statements (of which a prospectus is the main part) . . . echoes 10b-5: "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the

light of the circumstances under which they are made, not misleading." The redemption provision in the prospectus (quoted on page 5 above) was materially misleading in failing to say that redemption was permitted from the proceeds of common stock even though in anticipation of borrowing below 9.44%. This was particularly true in light of EDISON's undisclosed intents, beliefs and interpretations as to the redemption language it used. The redemption provision was also materially misleading in using the word "refunding" without explaining the very peculiar meaning that EDISON now assigns the word (and persuaded the trial Court to adopt). See page 29 below in Part 2.1(B).

Whether omissions from statements are violations of the antifraud provisions is determined "in the light of the circumstances under which they were made." 1933 Act § 17(a)(2); Rule 10b-5(2). The circumstances in this case included not only an elaborate 1933 Act prospectus but the prominent mention in that prospectus of a 5-year construction forecast of $2,250,000,000 of which $1,150,000,000 would be financed by the sale of securities. The preponderance of senior securities (debt and preferred stock) in the description of the construction program, in the capitalization table on p. 6 (57.3% long term debt, 8.7% preferred stock), and in the balance sheet on p. 19 made it clear that EDISON was anticipating selling much debt or preferred securities. In this context of steady anticipation of future financing by senior securities, and of the historically high 9.44% dividend rate on the STOCK, it was essential for EDISON to disclose exactly what it meant by the redemption language of the STOCK, and exactly what it had in mind as to redemption of the STOCK.

The trial Court stated: "The prospectus does not purport to link the construction program with the redemption terms." This ignores the "circumstances" just described and purpose of a

prospectus which is to be "read as a whole by a reasonable shareholder." *Allen v. Penn Central Co.*, 350 F.Supp. 697, 702 (E.D. Pa. 1972). The reasonable investor test of whether a statement is misleading is widely recognized. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. in banc 1968), cert. denied 394 U.S. 976 (1969), test applied on remand, 312 F.Supp. 77, 83-84 (S.D. N.Y. 1970), affirmed 446 F.2d 1301, 1304-05 (2d Cir. 1971), cert. denied 404 U.S. 1005 (1971); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 491 (9th Cir. 1974). This Court has used the same standards under the closely related antifraud provision of the 1934 Act proxy rules, referring to the reasonable shareholder and the "total mix" of information made available. *TSC Industries Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

A reasonable investor is supposed to read and consider the entire prospectus. That is precisely what the Plaintiffs did. It would be wholly inconsistent with the requirements and purposes of the securities laws to hold that a prospectus reader is to ignore page 4 (showing that EDISON, for years to come, will be in anticipation of issuing debt) when he interprets page 2 (saying that there will be no redemption in anticipation of debt below 9.44%). It would be equally inconsistent to let an issuer say that its disclosure obligations on page 2 have nothing to do with what it says on page 4.

If the redemption language used by EDISON was historically intended to permit redemption from common stock proceeds (as the trial Court suggests, App. p. A-17, *infra*), EDISON was in an unusually good position to know and disclose this in the prospectus. For the witness who testified to the history was an executive of the firm that acted as lead underwriter for EDISON's sale of the STOCK (Tr. 689).

EDISON has argued, and the trial Court seems to believe, (App. p. A-17) that EDISON is protected from liability be-

cause its redemption language was similar to that of other utilities. The main fallacy in this argument s that no other utility used it to redeem from the proceeds of common stock (Tr. 714). But there is another important thing to be noted: some companies were much more explicit, either expressly authorizing redemption from the proceeds of common stock (Detroit Edison, Tr. 322, 323) or expressly prohibiting it (Pacific Gas & Electric, Tr. 561, 598). Yet EDISON did neither. So it did not write just like everyone else, and it was unique in redeeming.

Additional evidence of the insufficiency and misleading quality of EDISON's disclosure of the redemption terms . . . if more is needed . . . can be found in the market history of the STOCK. As interest rates fell, the STOCK rose, and traded steadily and continuously above the $110 redemption price for all of 1971 (Pl. Ex. 23). This is irrefutable evidence that investors were misled on a grand scale, since no reasonable investor would pay more than $110 for a stock that he understood could be redeemed at will by the issuer for $110. The conclusiveness of market evidence of investor understanding is shown in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 at 866 (2d Cir. in banc 1968) (concurring opinion of Judge Friendly), cert. denied 394 U.S. 976 (1969). Closer to our facts is the reference in *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1379 (2d Cir. 1972) to market action and collective investor behavior as proof that the redemption notices for a convertible debenture were insufficient. To the same effect, regarding a notice that a tender offer had been oversubscribed, is *Indiana National Bank v. Mobil Oil Corp.*, 578 F.2d 180, 187 n. 15 (7th Cir. 1978): "This sharp drop in price was certainly an indication to an unsophisticated investor that a significant event had occurred."

The District Court's rejection of market evidence (App. p. A-18) on the ground investors might have thought EDISON incapable of issuing the common stock with which it was entitled to redeem . . . is sheer conjecture. It ignores the collective price-setting effect of investor belief in the market, recognized in the cases just cited. It assumes the point in issue: that EDISON adequately conveyed that the STOCK could be redeemed from common. It ignores the extensive testimony of investors, brokers and analysts. And it ignores the fundamental purpose of the securities laws, to protect investor through full disclosure.

EDISON's narrow view of disclosure is precisely the kind held inadequate in *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 564-565 (E.D. N.Y. 1971) (emphasis added):

> "The entire legislative scheme (of disclosure) can be frustrated by technical compliance . . . *in the absence of any real intent to communicate* * * *
>
> In at least some instances, what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding the air of total candor. Masters of this medium utilize turgid prose to *enshroud the occasional critical revelation in a morass* of dull, and—to all but the sophisticates—useless financial and historical data. In the face of such obfuscatory tactics the common or even the moderately well informed investor is almost as much at the mercy of the issuer as was his pre-SEC parent. *He cannot by reading the prospectus discern the merit of the offering.*"

In *Feit* the Court concluded:

> "Using a statement to obscure, rather than reveal, in plain English, the critical elements of a proposed business deal cannot be countenanced under the securities regulation acts * * * The prospective purchaser of a new issue is

entitled to know what the deal is all about." (332 F.Supp. 549)

Under the anti-fraud provisions of the Federal Securities Acts, stockholders must be fully and completely informed. Under these provisions there is no room for technical explanations and tight-lipped announcements, and all doubt arising from ambiguous statements must be resolved in favor of the stockholders. (*Gerstle v. Gamble-Skogmo, Inc.*, 298 F.Supp. 66, 95 (E.D. N.Y. 1969), affirmed (except as to computation of interest), 478 F.2d 1281 (2d Cir. 1973).

These principles further demonstrate the inadequacy of EDISON's disclosure about the redemption. The use of "stock language" which did not "provide meaningful disclosure" of or "reveal in plain English" the critical effect of the redemption language . . . as construed by EDISON . . . on investors. Clearly EDISON lacked "any real intent to communicate" on this subject and this "cannot be countenanced under the securities regulation acts". There is no room here for "technical explanations and tight-lipped announcements" of the kind EDISON made. Clearly this material information . . . this intent and interpretation of EDISON which would deprive the investors of their securities, just when the language seemed to assure they could continue to hold them . . . should have been made known to the investors.

1.3 EDISON's misrepresentations and omissions were with scienter.

(A) The Standard Is Recklessness.

It is now settled that negligence does not violate 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976). This Court expressly declined to rule whether recklessness will violate. 425 U.S. 194 n. 12 (penultimate paragraph). A ruling on that point is now timely.

The 7th Circuit, where this case arose, has consistently held that recklessness suffices for a 10b-5 violation. *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 993-994 (7th Cir. 1976) (as construed in *Sundstrand*, below); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040, 1043-1045 (7th Cir. 1977) cert. denied 434 U.S. 875 (1977); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792-793 (7th Cir. 1977); *Wright v. Heizer Corp.*, 560 F.2d 236, 246-248 (7th Cir. 1977) cert. denied 434 U.S. 1008 (1978).

Moreover, the recklessness test applies equally to misrepresentation (*Bailey*, above), to nondisclosure (*Sundstrand*, above; *Sanders*, above), and to schemes to defraud with elements of both misrepresentation and nondisclosure (*Wright*, above).

The test adopted by the Seventh Circuit is:

> "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." (*Sundstrand*, 553 F.2d 1045)

Recklessness cannot be measured by a needle on a meter. It must be inferred from the circumstances. The undisputed circumstances here include the supreme materiality of the information involved . . . the redemption terms of a fixed dividend stock issued at the height of a tight money period. The circumstances also include the kind of document EDISON was issuing . . . a statutory prospectus for a big offering and the sharp conflict of interest between EDISON and the holders of the STOCK as well as the careful financing forecast which EDISON did.

(B) Great Care Is Required in a $100 Million Offering.

EDISON must be judged on the writing of a prospectus for a $100 Million stock issue registered with the SEC . . . the largest preferred stock issue ever marketed (Tr. 732, 733). The potential for investor injury in so large an issue is itself large. The resources, time and skill available to write the prospectus correctly are also large. The standard of care required in such a prospectus is very high. See Securities Act of 1933, §11(a), 15 U.S.C.A. §§77k(a).

(C) Great Care Is Required When There Is a Conflict of Interest.

There was a conflict of interest between EDISON and the holders of the STOCK, centering on the high dividend (not deductible for EDISON's taxes) which EDISON would want to stop as soon as possible and which the holders would want to keep as long as possible.

Such a conflict of interest intensifies the duty to disclose and the method of disclosure. This is the teaching of *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976) where a controlling shareholder (Continental) violated 10b-5 by selling the corporation's assets for Meister Brau stock and selling its stock in the corporation to Meister Brau for cash, all in disregard of the minority shareholders' first refusal right to buy the controlling shares and without adequate disclosure to him. The Court noted that:

> "There was a clear conflict of interest between Continental's fiduciary duty as controlling shareholder to the Black Company and its minority shareholder Bailey and its objective of effecting the sale of the Black estate shares to Meister Brau.
>
> . . . Continental . . . blinded by conflict of interest, wantonly ignore(d) evidence of the unfairness of (the) securities transaction to the corporation and therefore fail(ed) to disclose this evidence to those shareholders whose interests lie with the corporation" (535 F.2d 993).

The same combination of conflict of interest and recklessness was found in *Wright v. Heizer Corp.*, 560 F.2d 236, 247, 248 (7th Cir. 1977), cert. denied 434 U.S. 1008 (1978).

(D) Great Care Was Taken in Preparing the Construction and Financing Forecast, and No Less Care Is Required in the Closely Related Redemption Terms.

We have already noted in Part 1.2 above, the intimate connection between EDISON's construction and financing forecasts (which determine its anticipation of debt) and the redemption terms of the STOCK (no redemption in anticipation of lower cost debt). EDISON's forecasts are elaborate and it represented to the Illinois Commerce Commission that its forecasts are made "with great care" and take into account, among other factors, "estimate(d) interest expense, based on current commitments and anticipated debt financing" (Pl. Ex. 80). What is reckless for a company to omit or misstate is surely related to the information it so carefully compiles on the same subject.

(E) EDISON Acted Recklessly in Writing the Redemption Terms of the Prospectus.

To sum up, EDISON was writing a solemn, detailed, Congressionally mandated disclosure document for a very large securities offering. The redemption language was a critically important part. Every dollar EDISON would save by redemption of the STOCK if interest rates declined would be at the expense of the STOCK holders. It was accustomed to detailed and careful financial forecasting. Yet all it chose to tell investors in the STOCK prospectus was:

> "(N)one of the . . . (STOCK) may be redeemed through refunding, directly or indirectly, by or in anticipation of

the incurring of any debt or the issuance of any shares of the (STOCK) or of any other stock ranking prior to or on a parity with the (STOCK), if such debt has an interest cost to the Company (as defined), or such shares have a dividend cost to the Company (as defined), less than the dividend cost to the Company of the (STOCK)."

Surely it was reckless . . . as a matter of law and on the overwhelming preponderance of the evidence . . . for EDISON to say this without saying what it concededly knew, believed and intended:, i.e. the five facts detailed in Part 1.2 above at page 18-19.

2. **EDISON's Redemption of the 9.44% Stock Was "Through Refunding Directly or Indirectly, by or in Anticipation of Any Debt" at a Lower Interest Cost to EDISON than the $9,440,000 Annual Dividend Cost to EDISON on the 9.44% STOCK and the Redemption Breached the Contract With Owners of the STOCK.**

2.1 **The meaning of the redemption contract (and the consequent breach) are established as a matter of law and also by the evidence.**

(A) The Evidence Shows Breach.

The prospectus for the STOCK provided that *none* of the STOCK *may be redeemed through refunding directly or indirectly, by or in anticipation of* incurring *any debt* or the issuance of any other shares of prior preferred stock *with an interest* or dividend *cost less than the 9.44%* required to be paid on this STOCK.

The Trial Court correctly noted that it is unquestioned that the redemption terms of preferred stock issues create a contract between the corporation and its stockholders (App. p. A-24, *infra*)

The Trial Court further found that there was no dispute surrounding the relevant facts and that EDISON redeemed the STOCK in March 1972 directly out of an issue of common stock and warrants at a time when its need for financing to continue the construction program was apparent. It is undisputed that the needed funds were available at interest costs less than 9.44%. It is undisputed that at the time of the redemption EDISON anticipated outside financing of over $2.3 Billion and at that time anticipated borrowing money at far less than 9.44% interest (Tr. 580). The Trial Court found:

> "Consistent with this construction forecast, Edison's long term debt increased from $1.849 billion at the end of 1971 to an amount in excess of $3 billion at the time of trial. Each issue of long term debt made by Edison, subsequent to the year 1971, was at an interest cost to Edison of less than 9.44%. During 1972, Edison also incurred debt through the issuance of short-term promissory notes. Edison's short-term debt on January 1, 1972, was $140 million, while at the end of 1972, it was $258 million. All the short-term commercial paper was issued at an interest rate of less than 9.44%." (App. p. A-9, *infra*)

These facts alone establish that the redemption was in breach of the contract because it was in anticipation of incurring debt below 9.44%.

(B) The Redemption Language Does Not Support the Lower Court's Holding That There Was No Breach.

The Trial Court wrestled earnestly with the redemption language and recognized its inadequacy. It acknowledged that:

> "The actions of Edison as shown by the evidence, could be characterized as redemption in anticipation of debt since it well knew its financing needs and that in the current market those needs could be met at a cost of less than 9.44%. If the redemption clause requires an exam-

ination of the entire borrowing activities of Edison then plaintiffs should prevail." (App. p. A-27, *infra*)

The Trial Court took the view that the clause forbidding redemption through refunding by or in anticipation of debt requires an examination only of the source of funds actually used to achieve the redemption and that the question is whether the proceeds of the issue of common stock and warrants were in anticipation of debt at an interest cost of less than 9.44%. The Court answers this in the negative because common stock cannot be refunded. It is true common stock cannot be refunded, only repurchased, but that is irrelevant. Even if this reasoning can be followed, it cannot be sustained by the redemption language. The latter deals with redemption or refunding in anticipation of lower cost financing, not with whether the source of funds was in such anticipation and not with whether the securities providing the funds could themselves be refunded.

There is no way the language of the redemption terms can support the Trial Court's reasoning. If "directly or indirectly, by or in anticipation" modifies only "redeemed", the redemption was plainly in anticipation of borrowing below 9.44%, as the Trial Court concedes. (App. p. A-27, *infra*) If the language modifies only "refunding" (construed as the sale of the common stock for money to pay for the redemption), the result is the same. The sale of common stock, occurring just before the redemption, was equally in anticipation of borrowing below 9.44%. If the language modifies only "refunding" (construed as giving the money back for the STOCK, i.e., redeeming it), the result is the same. We think the language modifies both "redeemed" and "refunding" (however construed) because of its placement, buttressed by "directly or indirectly" to indicate the broadest possible applicability. In this event, the result is again the same, but reinforced. (No one disputes that the redemption was through refunding of some sort). This is exactly the

word used by EDISON's Vice Chairman Corey in his inadequately disclosed statement of April 2, 1971: "* * * we expect to refund it when market conditions make it feasible to do so * * *." (Pl. Ex. 129; Def. Ex. 7).

The words "directly or indirectly" and 'in anticipation of' are everyday words and have no particular technical meaning in the investment community. The word "redeem" has the dictionary meaning "to buy back or to pay off." The word "refund" has the dictionary meaning of "giving back or to restore, to make repayment or to reimburse" or the more technical meaning "to pay off or redeem one security with the proceeds of sale of another security."

It follows that the contract with the STOCK holders was breached by redeeming or refunding in anticipation of borrowing below 9.44%. This is true as a matter of law (interpretation of the contract by the Court). It is equally true as a matter of fact (interpretation of the contract by buyers, brokers, analysts and the market as a whole, as detailed earlier).

2.2 If there is any doubt about the meaning of the contract, it should be construed strictly against EDISON on the principles of adhesion and contra proferentum.

If the redemption terms were somehow unclear or ambiguous they should be construed strictly against EDISON on well known principles of adhesion and Contra Proferentum.

The contract here was certainly one of adhesion. EDISON wrote the redemption terms, put them in the prospectus and offered them on a take-it-or-leave it basis to thousands or millions of investors, more than 4,000 of whom accepted (Pl. Ex. 5). See 3 Corbin, Contract Sec. 559 (1960); Kessler, Contracts of Adhesion—Some Thoughts About Freedom of Contract, 43 Colum. L. Rev. 629 (1943); Note, 54 Cornell L.Q. 271, 272-78 (1969) and authorities cited below.

While the Trial Court declined to apply adhesion rules, it did find the fact situation appropriate for the application of Contra Proferentum. This is a rule of contract interpretation which provides that when words of a contract have been chosen by one party and another merely assents to these words, that fact alone may tip the balance against the contracting party. The Trial Court found the doctrine of Contra Proferentum to be used to ascertain meaning where ambiguities remain but concluded there is no ambiguity to be construed against EDISON. With this we take issue. If the redemption language means what the Court says it does, this was not apparent to the readers to whom it was addressed . . . prospective buyers of the STOCK.

Construing an adhesion contract strictly against the writer is particularly appropriate when the presentation to the public is in a prospectus required by securities laws to make full disclosure and achieve fair treatment for investors, and when the extreme importance of the language is reflected by its prominence in the prospectus (page 2, the first text page) cross referenced by the very first line on the cover page following the designation of the STOCK. We are not here seeking construction of a pure commercial contract but a contract that is part of a prospectus for $100 million registered offering of securities to the public. We are not here solely for the construction of a contract as it may apply to sophisticated investors such as Petitioner and Texas Teachers who were misled, but for other institutional investors and the 3,771 individual investors owning an average of 61 shares each. Many of these have expressed their reliance upon the terms of the prospectus and other writings relating to the STOCK, such as Standard & Poor's, to mean that they could enjoy ownership of the STOCK until August 1, 1980. Their belief rested on a straightforward, common sense reading of the redemption terms, as we have shown in Part 2.1 above. This is precisely what was called for in *Standard Oil of California v. Perkins*, 347 F.2d 379, 383 (9th Cir. 1965), declaring that an

adhesion contract should be construed in accordance with its understanding by the "layman unversed in the law."

In *Gerstle v. Gamble-Skogmo, Inc.*, 298 F.Supp. 66, 95 (E.D. N.Y. 1969), affirmed (except as to computation of interest), 478 F.2d 1281 (2nd Cir. 1973) . . . Judge Bartels declared:

> "Under the anti-fraud provisions of the Federal Securities Acts, stockholders must be fully and completely informed. Under these provisions there is no room for technical explanations and tight-lipped announcements, and all doubt arising from ambiguous statements must be resolved in favor of the stockholders."

His statement applies adhesion principles to securities law disclosure documents (proxy statements) much like the prospectus we have here.

Also supporting the adhesion doctrine in application to publicly held securities is *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1383 (2d Cir. 1975), on damages 553 F.2d 812 (2d Cir. 1977), on counsel fees 573 F.2d 733 (2d Cir. 1978), 590 F.2d 433 (2d Cir. en banc 1978) cert. granted May 14, 1979 (Dkt. 78-1327). The first opinion held, apparently as a matter of state law, that the notice given for redemption of debentures was "simply insufficient to give fair and reasonable notice" even though "it may have conformed to the requirements of the Indenture."

There should be no room in this case for technical explanations and tight-lipped announcements; all doubts arising from ambiguous statements should be resolved in favor of the stockholders.

The circumstances that called for strict interpretation against EDISON are highlighted in the Trial Court's final words:

"Although I believe Edison could have avoided this entire matter by making its right express, I cannot say that Edison's drafting, which stated expressly the methods by which redemption was prohibited and impliedly reserved to itself all other methods, violated the Federal Securities Laws or violated plaintiffs' vested contract rights. The decision here has not been quick nor easy. Drafting could have alleviated not only the time and effort spent here but the unrewarded expectations of plaintiffs." (App. p. A-32, *infra*)

The Court below found that EDISON could have avoided the entire matter by making its right express. This is true. EDISON knew on June 24, 1970 (when the STOCK was issued) that EDISON had the intent to redeem this STOCK when market conditions made it feasible to do so and it was advantageous to common stockholders, and interpreted the redemption terms as giving it the right to do so. This was unknown to the investors and it was material information which, if known to the investors, would have led them to invest their funds elsewhere.

3. **Edison Breached Its Contract With the New York Stock Exchange Which Was for the Benefit of the Holders of the Stock.**

The STOCK was listed on the New York Stock Exchange (NYSE) and EDISON, like all other companies whose securities are listed on the NYSE, had a listing agreement with the NY SE (Tr. 416). Although notified by the Plaintiff to produce its listing agreement, EDISON failed to do so, but stipulated in open Court that the redemption provisions of EDISON's listing agreement were the same as quoted in *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1376 (2d Cir. 1975) (Van Gemert I), on damages, 553 F.2d 812 (2d Cir. 1977), on counsel fees, 573 F.2d 733 (2d Cir. 1978), 590 F.2d 433 (2d Cir. en banc

1978), cert. granted May 14, 1979 (Dkt. 78-1327). The listing agreement in *Van Gemert I* reads in relevant part:

"The Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to * * * any rights or benefits pertaining to the ownership of its securities * * * " (520 F.2d 1376).

"Section A10 of the NYSE 'Company Manual' specifically defines what is meant by publicity in the Listing Agreement:

'Publicity: The term "publicity" as used * * * in the listing agreement in *respect of a redemption action*, refers to a general news release, and not to the formal notice of advertisement of redemption sometimes required by provisions of an indenture or charter.

'Such news release shall be made *as soon as possible after corporate action which will lead to, or which looks toward, redemption is taken* * * * and shall be made by the fastest available means, i.e., telephone, telegraph or hand-delivery.

'To insure coverage which will adequately inform the public, the news should be released to at least one or more newspapers of general circulation in New York City, which regularly publish financial news, or to one or more of the national news-wire services (Associated Press, United Press International), in addition to such other release as the company may elect to make.' " (520 F.2d 1376-1377.) (Emphasis supplied.)

Under *Van Gemert I*, holders of redeemable securities are third party beneficiaries of the listing contract with the NYSE; Defendant's liability arose out of a failure to provide fair and reasonable notice of redemption. The redemption notice required in the listing agreement is obviously for the benefit of the holders of the STOCK and potential holders . . . buyers

in the open market after the happening of the event which requires the notice.

The District Court, without reaching related issues, found adequate release of the redemption plans to satisfy the NYSE requirements (App. p. A-24, *infra*). The release was by (1) a proxy statement dated February 25, 1971 for an annual meeting to be held on April 2, 1971, stating that new preference or common stock may be sold to retire all or part of the STOCK although the company has no definitive plans (Def. Ex. 6), and (2) a report of annual meeting held on April 2, 1971, stating "In the future, we expect to take advantage of changes in the money market as they occur * * *" and "We were disappointed in the 9.44% dividend rate on the prior preferred stock we sold last August, but we expect to refund it when market conditions make it feasible to do so." (Pl. Ex. 129, Def. Ex. 7).

EDISON's Vice Chairman Corey, who was chief financial officer of EDISON at all times relevant to the issue, claims that EDISON intended to tell of these plans to the investment community on April 2, 1971 (Tr. 480), but concedes that EDISON's efforts to tell the investment community about its intention to redeem the STOCK when market conditions were favorable were not as successful as EDISON might have hoped (Tr. 477). The following is the significant sequence in his testimony appearing on Tr. 481:

> Q. Well, it says here, "To insure coverage which will adequately inform the public, the news should be released to at least one or more newspapers of general circulation in New York City, which regularly publish its financial news." You didn't do that, did you?
>
> A. We didn't do it because——
>
> Q. You didn't do it, did you?
>
> A. That's correct.

Although EDISON was called upon to produce a record of its publication of action taken at the stockholders meeting on April 2, 1971, this was not produced (Tr. 765). It did produce a witness who testified to mailing a proxy statement and report of the annual meeting to 190,000 shareholders, to 1,134 analysts and brokers and to 260 newspapers including the Wall Street Journal, New York Times and Associated Wire Press. This information relating to redemption "when market conditions made it feasible to do so" was buried within the proxy statement and within the report of annual meeting so no publication was made for the benefit of the investing public. In the proxy statement, the information occupies five lines on page 6 of a 28-page document (Def. Ex. 6). The reference to the annual meeting on April 2, 1971 is contained in three lines on page 5 of a 15-page summary of the meeting (Def. Ex. 7). Such buried facts are not adequate disclosure. *Kohn v. American Metal Climax, Inc.*, 322 F.Supp. 1331, 1362 (E.D. Pa. 1971), affirmed on this point, 458 F.2d 255, 265 (3rd Cir. 1972), cert. denied 409 U.S. 874 (1972); *Gould v. American Hawaiian Steamship Co.*, 331 F.Supp. 981, 995-96 (D. Del. 1971), vacated on other grounds 535 F.2d 761, 773-74 (3d Cir. 1976); *Robinson v. Penn Central Co.*, 336 F.Supp. 655, 657 (E.D. Pa. 1971). We submit that this is not the publicity required by the listing agreement of the NYSE. What financial reporter or newspaper editor is going to wade through all these pages in hopes of finding something to print? The material was not printed. No wonder some people paid $119 per share in the market a few days before the redemption was finally announced as required by the Rules. The law and the NYSE require a greater and much more specific notice than EDISON gave.

There is ample proof that EDISON failed to inform the market. The market wholly failed to react; see Part 1.2, pp. 22-23 above. Stock broker Schoettler, who was recommending . . . and whose customers were buying . . . the STOCK in the secondary

market, believed that it would not be possible for EDISON to redeem the STOCK before 1980 (Tr. 244-247). So did the investors who bought the STOCK in the secondary market and wrote unhappily to EDISON (Pl. Ex. 92-121). Plaintiffs' Exhibit 102 (Rubach: purchased in good faith at $117 in March 1971); Plaintiffs' Exhibit 112 (Pizza Food Products: 3,000 shares at prices from $119 to $120; our investment was made at a substantial premium over par only after a careful review of the prospectus); Plaintiffs' Exhibit 115 (Hendricks: 23 shares at $117.50 on August 26, 1971 and 6 shares at $120.75 on September 15, 1971; Standard & Poor's showed redemption restricted to 8-1-80); Plaintiffs' Exhibit 118 (Brusenbach: senior citizens trying to better our income by buying 200 shares at $119.50 on November 12, 1971; "we were not given to understand that you could redeem at your will"); Plaintiffs' Exhibit 131 (Salomon Bros. price list for marketable securities showing the STOCK NR80, meaning non-redeemable before 1980).

EDISON's replies to these shareholders conceded that it had not adequately informed the market. Its Corporate Secretary Kavanagh wrote Lloyd Hendricks on Feb. 25, 1972 (Pl. Ex. 115) saying EDISON had tried to disclose, but admitting: "However, it is plain that much of the investment community apparently was not already alerted to this possibility." On Feb. 24 he wrote another shareholder (Pl. Ex. 101): *"Evidently our warnings about the redemption were widely disregarded in the investment community, because the price of the Stock instead of staying near the redemption price of* $110 *rose with interest rates"* (emphasis supplied).

When EDISON did finally comply with the NYSE publication requirements on Jan. 5, 1972, the market for the STOCK dropped more than $8 a share, to the redemption price ($110) plus accrued dividends. Vice Chairman Corey said this was a normal reaction to a pinpointed announcement of redemption (Tr. 414). The Trial Court agreed that it was a normal reaction (App. p. A-11, *infra*).

Had EDISON complied with the NYSE requirements in Apr. 1971 the market would have topped out around $110. Instead, we have a class of buyers of at least 147,300 shares after Apr. 2, 1971 at prices up to $10 above the redemption price (average $7.18 above the redemption price) who suffered an out of pocket loss of more than $1 million. These person are the third party beneficiaries of the NYSE publication requirements in the listing agreement and were grievously injured by EDISON's breach of the agreement.

4. **EDISON Violated the Fraud Provisions of the Federal Securities Laws When It Redeemed the 9.44% Stock.**

The redemption before this Court was a purchase and a sale. In a redemption, a shareholder gives up his shares and receives cash. Thus he makes a "disposition of a security . . . for value," within the meaning of "sale" in 1933 Act § 2(3), 15 U.S.C.A. § 77b(3). Correspondingly, the redemption is a "purchase" by the redeeming company. *Drachman v. Harvey*, 453 F.2d 722, 737 (2d Cir. in banc 1972).

It is well settled that a scheme to defraud in connection with a redemption is a violation of the securities laws (*Drachman v. Harvey*, 453 F.2d 722, 736-38 (2d Cir. in banc 1972); *Levine v. Seilon*, 439 F.2d 328, 332 (2d Cir. 1971); *Speed v. Transamerica Corp.*, 99 F.Supp. 808, 843-49 (D. Del. 1951), 135 F.Supp. 176 (D. Del. 1955), affirmed 235 F.2d 369 (3d Cir. 1956); see *Van Gemert v. Boeing*, 520 F.2d 1373 (2d Cir. 1975), on damages, 553 F.2d 812 (2d Cir. 1977).), on counsel fees 573 F.2d 733 (2d Cir. 1978), 590 F.2d 433 (2d Cir. en banc 1978), cert. granted May 14, 1979 (Dkt. 78-1327).

The redemption here was more than reckless; it was intentional. It was a conscious deliberate act taken by EDISON with full corporate formality to obtain benefits including cash savings by termination of the high dividends on the 9.44% STOCK. Vice

Chairman Corey and Chairman Ward declared the redemption is being made to increase cash flow (Pl. Ex. 92 and 94, respectively) and at this time EDISON knew that the investment community was not alerted to the possibility of redemption (Tr. 438) and that its communication efforts were not as successful as it "might have hoped" (Tr. 479).

The only possible conclusion is that the market did not understand the redemption terms as EDISON did and that EDISON was brazenly indifferent to the plight of investors like Mr. and Mrs. Frank Brusenbach who bought 200 shares of the STOCK on November 12, 1971 at $119.50 per share and would sustain an out-of-pocket loss of $1,900 by the time the redemption was completed three months later (Pl. Ex. 118). This loss was, to paraphrase the Court, below, "the market's normal reaction to EDISON's plans to redeem the STOCK." (App. p. A-11, *infra*) EDISON was in direct conflict of interest with the holders of the STOCK since they would lose and it would gain by the redemption. EDISON went relentlessly ahead and destroyed more than $8 Million of market value of the STOCK. EDISON brought this loss upon the investors at a time it had forecast more than $1.5 Billion of outside financing and anticipated financing at a net interest cost of less than 9.44%. This redemption was in anticipation of lower cost debt financing, and in violation of the redemption language. The redemption was in utter disregard of the rights of the holders of the STOCK. The redemption was carried out after EDISON received numerous protests and complaints that it had no right to redeem. Plaintiffs' Exhibit 11, the prospectus dated February 22, 1972 for units of common stock with warrants, sets forth on page 6 that EDISON, prior to the redemption, acknowledges receipt of communications from shareholders protesting redemption and claiming the prospectus did not clearly indicate there could be a redemption prior to August 1, 1980 and claiming that EDISON indicated it could not redeem because it would continue to use debt as a part of a

continuing program to finance construction which might have a lower cost than the 9.44% dividend.

It would be hard to find a better description of EDISON's redemption than the language the Seventh Circuit has twice used recently to describe sufficient scienter for a 10b-5 violation: "Blinded by a conflict of interest, (Defendant) wantonly ignore(d) evidence of the unfairness of the securities transaction * * *" *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 993 (7th Cir. 1976); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977) cert. denied 434 U.S. 1066 (1978).

CONCLUSION

For the reasons stated, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX.

APPENDIX A

Opinion of the Court of Appeals

In the United States Court of Appeals
for the Seventh Circuit

No. 78-1896

The Franklin Life Insurance Company, et al.,

Plaintiffs-Appellants,

v.

Commonwealth Edison Company,

Defendant-Appellee.

Appeal from the United States District Court for the Southern District of Illinois, Southern Division.

No. S-Civ-72-37—J. Waldo Ackerman, Judge.

Argued February 21, 1979—Decided May 22, 1979.

Before PELL and BAUER, Circuit Judges, and NOLAND,* District Judge.

PER CURIAM. This action arose out of the issuance and subsequent redemption of one million shares of 9.44% Cumulative Prior Preferred Stock at a par value of $100 per share by the defendant. The plaintiffs alleged violations of §§ 11 and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77k and 77q, and § 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b) and

* District Judge James E. Noland of the Southern District of Indiana is sitting by designation.

Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. They also alleged a breach of contract claim based on the redemption terms in the prospectus and in the defendant's Articles of Incorporation, and a third party beneficiary claim based on the defendant's alleged violation of its listing agreement with the New York Stock Exchange.

After trial, the district court entered judgment for the defendant on all counts and issued a thorough and well-reasoned memorandum order addressing each issue. 451 F.Supp. 602 (S.D. Ill. 1978). The issues on appeal are virtually identical to those before the district court. Because we are of the opinion that the district court reached the correct result for the proper reasons, we adopt as our own that court's opinion except for the last paragraph on page 615 and the first paragraph on page 616. These two paragraphs are not essential to the result, and accordingly we do not deem it appropriate to reach the issue there addressed.

The judgment of the district court is Affirmed.

APPENDIX B

Judgment of the Court of Appeals

Per Curiam Opinion
United States Court of Appeals
for the Seventh Circuit
Chicago, Illinois 60604

May 22, 1979

Before

Hon. Wilbur F. Pell, Jr., Circuit Judge
Hon. William J. Bauer, Circuit Judge
Hon. James E. Noland, District Judge*

Franklin Life Insurance Company, a Corporation, Individually and Representatively on Behalf of All Holders of the 9.44% Cumulative Prior Preferred Stock of Commonwealth Edison Company, a Corporation,
Plaintiffs-Appellants,

vs.

Commonwealth Edison Company, a Corporation,
Defendant-Appellee.

Appeal from the United States District Court for the Southern District of Illinois, Springfield Division

No. S-Civ-72-37

J. Waldo Ackerman, Judge

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Illinois, Springfield Division, and was argued by counsel.

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* Honorable James E. Noland, Judge, United States District Court for the Southern District of Indiana, sitting by designation.
No. 78-1896

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, Affirmed, with costs, in accordance with the opinion of this court filed this date.

APPENDIX C

Order on Petition for Rehearing

United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

June 27, 1979

Before

Hon. Wilbur F. Pell, Jr., Circuit Judge

Hon. William J. Bauer, Circuit Judge

Hon. James E. Noland, Circuit Judge*

The Franklin Life Insurance Company, et al., Plaintiffs-Appellants, No. 78-1896 vs. Commonwealth Edison Company, Defendant-Appellee.	Appeal from the United States District Court for the Southern District of Illinois, Southern Division. No. S-Civ-72-37 J. Waldo Ackerman, Judge

On consideration of the petition for rehearing and suggestion for rehearing *en banc* filed in the above-entitled cause by plaintiffs-appellants, The Franklin Life Insurance Company, et al., no judge in active service has requested a vote thereon** and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

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* The Honorable James E. Noland, District Judge for the Southern District of Indiana, Indianapolis Division, sitting by designation.

** Judges Tone and Wood disqualified themselves from consideration of the petition for rehearing *en banc* filed in the above case.

APPENDIX D

Memorandum Order of the District Court

This action arises out of the issuance and subsequent redemption of one million shares of 9.44% Cumulative Prior Preferred Stock at a par value of $100 per share, by defendant Commonwealth Edison Company. Trial on the issue of liability has been had before the Court sitting without a jury and the points presented have been ably briefed and argued by the parties. This Memorandum Order shall incorporate within its text the Court's findings of fact and conclusions of law, pursuant to F.R.Civ.P. 52(a).

Plaintiff, Franklin Life Insurance Company, filed this action individually and as representative of the class of persons holding the stock on or after January 4, 1972. Subsequently, other class members including the Teacher Retirement System of Texas, were either granted leave to intervene or entered their appearance in this action through various counsel.

The action was certified as a class action under F.R.Civ.P. 23(b)(3). The class consisted of 5,828 shareholders of the Edison Stock as of January 4, 1972, and thereafter. Pursuant to the notice required, 1,317 shareholders filed a written election to be excluded from the class leaving 4,511 members of the plaintiff class. The Court's certifying order, consistent with F.R.Civ.P 23(c)(1), was conditional, thus allowing the class to be modified or altered prior to a decision on the merits.

The claims of plaintiffs can be basically divided into two categories, those based on alleged violations of the Federal Securities Acts and those based on breach of contract theories. The real crux of the matter is whether the redemption provisions contained in the prospectus and the actions taken by defendant thereunder, can be said to have either breached defendant's contractual obligations or materially misled plaintiffs in violation of the Federal Securities Laws.

Plaintiffs, on the securities claims, allege violations of §§ 11 and 17 of the Securities Act of 1933, 15 U.S.C. § 77k and 15 U.S.C. § 77q respectively, as well as Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 CFR § 240.10b-5, promulgated thereunder. On the contract claims, plaintiffs assert first that defendant redeemed in violation of the redemption terms as set out in the prospectus and in Edison's Articles of Incorporation and since those terms constitute an agreement between Edison and each of its shareholders, Edison must respond in damages for breach of contract. Further, plaintiffs claim that defendant failed to sufficiently publicize actions taken which looked toward the redemption of the Stock in violation of its listing agreement with the New York Stock Exchange, which plaintiffs assert, gives rise to a third party beneficiary action on that contract.

While each of these claims will be examined in more detail, for the reasons stated below and on the evidence presented, I find judgment must be for defendant on all counts.

I

In general, the facts surrounding this litigation are not in dispute. On June 24, 1970, defendant sold through its underwriters, one million shares of its 9.44% Cumulative Prior Preferred STOCK (hereinafter STOCK) at the offering price of $100 per share. Plaintiff, Franklin Life Insurance Company (hereinafter Franklin), purchased 25,000 shares of the STOCK at the asking price on or about June 24, 1970. Intervenors, the Teachers Retirement System of Texas (hereinafter Texas Teachers), purchased 30,000 shares at the asking price and took delivery, under a delayed delivery agreement on May 4, 1971. Both Franklin and Texas Teachers examined the prospectus

issued by defendant in conjunction with its stock issue and relied on that prospectus when purchasing the STOCK.

At the time the STOCK was issued, investment funds were in short supply and as a result preferred stock issues bore an uncharacteristically high rate of return. Because of this high rate of return and because of the STOCK's redemption provisions, both Franklin and Texas Teachers purchased the STOCK as a long-term investment.

Although defendant preferred to issue the STOCK with a 9.25% dividend rate and a five year redemption restriction period, defendant was convinced through negotiations with its underwriters, primarily the First Boston Corporation, that a dividend rate of 9.44% and a ten year redemption restriction period were required for a successful stock issue. These terms were incorporated in the prospectus issued in connection with the sale of the STOCK and in EDISON'S Articles of Incorporation.

The prospectus provided on page 1 that the STOCK was:

> [n]ot redeemable, directly or indirectly, prior to August 1, 1980, through certain refunding operations (See page 2).

On page 2 of the prospectus, the text of the redemption provision provided:

> [p]rior to August 1, 1980, *none* of the shares of the 9.44% Prior Preferred STOCK *may be redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt or the issuance of any shares of the Prior Preferred* STOCK *or any other stock ranking prior to or on a parity with the Prior Preferred* STOCK, *if such debt has an interest cost to the Company (as defined), or such shares have a dividend cost to the Company (as defined), less than the dividend cost to the Company of the 9.44% Prior Preferred Stock.* Subject to the foregoing, the 9.44% Prior Preferred STOCK will be redeemable at the option of the Company as a whole at any time or in part from time to time at the following per share redemption prices: $110 if redeemed before August 1, 1980; $107 if redeemed on or after August 1, 1980, but before August 1, 1983; $104 if redeemed on or after August 1, 1983, but before August 1, 1986; and $101 if redeemed on or after August 1, 1986; in each case plus accrued and unpaid dividends, if any. (Emphasis added.)

The prospectus also contained a section entitled "Purpose of Issue and Construction Program" on pages 4 and 5. That section stated that the net proceeds from the sale of the STOCK would be added to working capital for application in part toward repayment of short-term commercial paper and primarily for interim financing of the construction program. This section of the prospectus then described the construction program and stated that the program for the next five year period, 1970-74, "as now forecast, calls for electric plant expenditures of approximately $2,250,000,000." Of that amount, it was estimated that $1,150,000,000 would have to be raised through the sale of additional securities of the company.

Consistent with this construction forecast, EDISON'S long term debt increased from $1,849 billion at the end of 1971 to an amount in excess of $3 billion at the time of trial. Each issue of long term debt made by EDISON, subsequent to the year 1971, was at an interest cost to EDISON of less than 9.44%. During 1972, EDISON also incurred debt through the issuance of short-term promissory notes. EDISON'S short-term debt on January 1, 1972, was $140 million, while at the end of 1972, it was $258 million. All the short-term commercial paper was issued at an interest rate of less than 9.44%.

The mails and instrumentalities of interstate commerce were used in the sale of the STOCK and the STOCK was listed and traded on the New York, Midwest and Pacific Stock Exchanges after August 13, 1970, and until the redemption of the STOCK.

At the time the STOCK was issued, defendant believed that in accordance with the redemption terms, it could redeem the STOCK from the proceeds of common stock or other junior security offerings without regard to its borrowing activities.

On February 2, 1971, EDISON issued its proxy statement for the 1971 annual meeting. The shareholders at that annual meeting were requested to vote on two proposals pertinent here. The first was an amendment to EDISON'S Articles of Incorporation increasing the number of authorized shares of common stock from 60 million to 75 million shares, and the second sought to authorize the creation of a new class of preferred stock. At page 6 of the proxy statement defendant stated:

> Also, it is anticipated that the new Preference Stock or additional Common Stock, or shares of both such classes, may in the future be sold to redeem or otherwise used to retire all or part of the 9.44% Series of Prior Preferred Stock. However, the Company has no definitive plans at the date of this proxy statement for issuance of additional equity securities.

At EDISON'S annual meeting on April 2, 1971, defendant's Vice-Chairman Gordon Corey was quoted in the report of the annual meeting as saying:

> We were disappointed in the 9.44% dividend rate on the prior preferred stock we sold last August, but we expect to refund it when market conditions make it feasible to do so.

The report of the annual meeting also contained a statement of defendant's Chairman J. Harris Ward in response to a question

from a stockholder, that EDISON did not intend to issue common stock in the near future.

Throughout 1971 and until January 5, 1972, when the announcement of EDISON's intent to redeem the stock appeared in the Wall Street Journal, the STOCK was traded on the exchanges at prices continually above the $110 redemption price. EDISON monitored the trading of the STOCK on the exchanges and was aware of this fact. On January 4, 1972, the STOCK was trading at $119.6875 per share. On January 5, 1972, after the announcement had appeared in the Wall Street Journal, the price of the STOCK fell to $111.375, a value approximating the $110 redemption price plus accrued dividends. Those holding the STOCK on January 4, 1972, suffered a loss of $8.3125 per share in the course of the market's normal reaction to EDISON's plans to redeem the STOCK.

On February 2, 1972, EDISON, pursuant to the terms of a prospectus, offered common stock and warrants to the common stock holders of EDISON. That offer was fully subscribed. EDISON segregated the proceeds of the common stock and warrants offering and redeemed the STOCK out of those proceeds on or about March 20, 1972, at the redemption price of $110 per share plus accrued interest.

II

Plaintiffs assert that both the original sale of the STOCK and its subsequent redemption violated the cited securities laws. At the heart of plaintiffs' various claims is the assertion that the prospectus when read as a whole, and particularly the redemption provision, when read in conjunction with the construction forecast, led plaintiffs to believe that the STOCK could not be redeemed for ten years, that is, prior to August 1, 1980. The key to this interpretation of the prospectus, is the language in

the redemption provisions which stated that prior to August 1, 1980, none of the shares of the STOCK might be redeemed "through refunding, directly or indirectly, by or in anticipation of the incurring of any debt . . ."

The bulk of plaintiffs' arguments on the securities law counts have been concerned with the alleged violation of Rule 10b-5. Since the elements of a claim under both §§ 11 and 17 of the 1933 Act have been interpreted to be either more restrictive or coterminous with the elements required under Rule 10b-5,[1] this opinion will be limited to the 10b-5 claim and the § 11 and § 17 claims governed by the result under 10b-5.

Rule 10b-5, promulgated by the Securities and Exchange Commission under authority granted in 15 U.S.C. § 76j(b), provides:

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[1] Section 11 of the 1933 Act, 15 U.S.C. § 77k, provides civil liability for false registration statements. Section 11 however, has been interpreted generally as being limited to damages for purchasers at the original offering, thus excluding those members of the plaintiff class who purchased in a secondary market. See, In Re Equity Funding Corp. of America Securities Litigation, 416 F.Supp. 161, 186-88 (C.D.Calif. 1976). Further, at least the Securities and Exchange Commission believes that damages under Section 11 are not recoverable where plaintiff disposed of the security at a price in excess of the offering price. See, SEC Release No. 45, 11 Fed.Reg. 10947 (Sept. 22, 1933).

Section 17 of the 1933 Act, 15 U.S.C. § 77q, provides that it shall be unlawful for any person in the offer or sale of any security to use any of the means or instrumentalities of interstate commerce to consummate a fraudulent transaction. This section is often pled in conjunction with claims under Rule 10b-5. Liability under Section 17 has been considered coterminous with liability under Rule 10b-5. SEC v. Texas Gulf Sulphur, 401 F.2d 833 at 867 (2nd Cir. 1968) (concurring opinion of Friendly, J.), and said to require a finding of scienter as in 10b-5 cases. Sanders v. Nuveen & Co., Inc., 554 F.2d 790, 795-796. (7th Cir. 1977). Further, Section 17 contains no express provision for any civil remedy and thus such a remedy must be judicially implied. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 n. 6 (1975), the United States Supreme Court reserved ruling on this precise issue, and I do not feel it necessary to reach it here.

> [i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of a national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the sale or purchase of any security. 20 CFR § 240.10b-5.

Plaintiffs make two basic claims under Rule 10b-5. First, it is asserted that defendant omitted a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading. More specifically, plaintiffs assert that defendant's intent to redeem the stock with an issue of common stock and warrants when market conditions made it feasible to do so, and defendant's belief that the redemption provisions of the prospectus allowed such a redemption without regard to defendant's borrowing transactions, were omissions of material fact necessary, in order to make statements made, in light of the circumstances under which they were made, not misleading. Secondly, the plaintiffs urge that the redemption, in light of these omissions, must have been a device, scheme, or artifice to defraud.

A private plaintiff under Rule 10b-5, bears the burden of proving by a preponderance of the evidence that he was a purchaser or seller of the security;[2] that there was a misstatement,

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[2] Blue Chip Stamps et al. v. Manor Drugstores, 421 U.S. 723 (1975).

nondisclosure, or scheme to defraud;[3] that the non-disclosure or misstatement was of a material fact, i.e., a fact that a reasonable investor might have considered important in making his investment decision;[4] that there was reliance, that is, a causal relationship between the violation of the rule and the injury;[5] and that defendant acted with a mental state embracing an intent to deceive, manipulate, or defraud,[6] or alternatively that defendant recklessly misstated or omitted a material fact.[7]

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[3] Santa Fe Industries, Inc., et al. v. Green, et al., 430 U.S. 462 (1977).

[4] Affiliated Ute Citizens v. U. S., 406 U.S. 128, 153-154 (1972).

[5] This element is presumed where a material omission is found. Affiliated Ute Citizens v. U. S., 406 U.S. 128, 153-154 (1972). TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 447, n. 9 (1975).

[6] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n. 12 (1976).

[7] Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977). In this case the Seventh Circuit defined recklessness for 10b-5 purposes in the following manner:

> reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or so obvious that the actor must have been aware of it. 553 F.2d 1033, 1045.

Further, the Court of Appeals for the Seventh Circuit said of this definition that "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing," Sunstrand, supra, at 1045, and that "[t]his is an objective test although the circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight." Sunstrand, supra, at 1045. n. 19.

Since Sunstrand, the Seventh Circuit has further defined the scope of recklessness saying:

> We believe "recklessness" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it would be not just a difference in degree, but also in kind. Sanders v. Nuveen & Co., Inc., 554 F.2d 790, 793 (7th Cir. 1977).

In this case, under either of the transactions asserted as violations of Rule 10b-5, the issuance or redemption of the stock, the class of plaintiffs here, by definition, purchased and sold the stock. Further there was undisputed testimony that the omissions charged were material, and that being the case, reliance is to be presumed.[8] The crucial questions are whether there was a non-disclosure or a scheme to defraud and, if so, did defendant act with a mental state appropriate for the imposition of liability?

A. STOCK ISSUE

Looking first at the time the STOCK was issued, the "omissions" charged have relevance only in light of plaintiffs' interpretation of the redemption provision. Plaintiffs interpreted that portion of the redemption provision reading, "none of the shares of the 9.44% Prior Preferred Stock may be redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt . . ." as prohibiting any refunding so long as defendant was borrowing money at interest cost of less than 9.44%. Thus, from the time of issuance until August 1, 1980, plaintiffs believed redemption could not be accomplished so long as defendant was a "net borrower", that is, borrowing more money per year than it repayed. The construction forecast in the prospectus, when read with plaintiffs' interpretation of the redemption language, rendered the stock uncallable prior to August 1, 1980. The testimony has established, that had plaintiffs known either of defendant's intent to redeem when market conditions made it feasible or of defendant's belief that redemption could be accomplished out of the issuance of common stock prior to August 1, 1980, without regard to the debt incurred, they would not have purchased.

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[8] See note 5, supra.

In order to establish an omission under Rule 10b-5, plaintiffs must show that defendant omitted a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. The material facts assertedly omitted here are not objective. They are subjective. What plaintiffs would require are statements of defendant's intent and of defendant's beliefs concerning the proper interpretation of the redemption provision. Whether the security laws are broad enough to require the disclosure of such facts is, in my mind, open to serious question.[9] Further, whether the language of the prospectus adequately disclosed these facts is another question on which I express no opinion.

Assuming, however, that the securities laws require this type of disclosure and that the prospectus did not adequately disclose these facts, the question remains whether the non-disclosure was done intentionally or recklessly or as part of a scheme or artifice to defraud.

An examination of the prospectus does not reveal any intent to mislead nor does it reveal any recklessness. The prospectus does not purport to link the construction forecast with the redemption terms. The summary of the redemption terms appearing on page 1 purports to limit defendant's right to redeem only through "certain refunding operations." The redemption provision, arguably, forebade refunding through the proceeds of a stock issue, only if that stock ranked prior to or on a parity with the stock here in question and at an effective cost to the company of less than 9.44%.

There was no evidence that defendant was aware of any "net borrower" theory. Nor was there any evidence that redemption

[9] The thing misrepresented or not disclosed must be material information, which perhaps includes something more than firm fact, but does not include opinion or interpretation. Blomberg, Alan R., Securities Law, Vol. 3 p. 197 (1977).

of a preferred stock issue through the proceeds of a common stock issue had ever been thwarted by language similar to "directly, indirectly, by or in anticipation of any debt,"—when coupled with increasing debt.

Defendant's witness Edward Lebens, a former Vice-President and Director of the underwriting First Boston Corporation, testified that the genesis of the "directly, indirectly, by or in anticipation of any debt" language grew out of a situation in the 1930's and 40's where corporations would issue bonds at a given rate of interest and within a very short period of time, refinance that issue with a subsequent issue at a lower rate. The language, Mr. Lebens testified, was designed to prevent this type of redemption, but not to prevent the redemption out of an issue of common stock. Further, the various prospecti concerning the issue of other utility preferred stock establish conclusively that although the language in the prospectus here at issue may be slightly different, it is not aberrational. The fact that Edison used similar language in a 1957 preferred stock issue which in turn, was redeemed in 1962, is entitled to some weight even though the conditions of that redemption varied greatly from those here under consideration.

Under these circumstances, the evidence fails to support a finding that defendant either intentionally or recklessly, failed to disclose a material fact necessary, to make the statements made not misleading. The evidence fails to support a finding of scienter. Therefore, there can be no securities law violation surrounding the issuance of the stock and judgment must be for defendant.

B. REDEMPTION

Edison's redemption is asserted to give rise to liability under Rule 10b-5 in two ways. It is argued first, as the capstone of an Edison scheme to defraud purchasers of the Stock and second,

as a breach of the duty, under Rule 10b-5, to continually inform the market of material information. Under both theories, the gravaman of the complaint is defendant's failure to reveal its belief in its right to redeem out of common stock and its intent to do so when market conditions made it feasible.

These omissions are subject to the same questions raised and reserved in Part I.A. above. Because I held in that section of the opinion, that no finding of scienter could be made, no finding of a scheme to defraud existing from issuance through redemption can be made.

However, another factor is added to that analysis in plaintiff's argument here. That factor is the assertion that Edison, at some point, through its monitoring of the market, must have known that the market did not interpret the redemption provisions as did defendant. The argument is premised on two points. First, that the current market price is an accurate indicator of the market's knowledge about the stock, including its redemption provisions, and secondly, that no reasonable investor knowing Edison's belief in its right to redeem and its intent to do so when market conditions made it feasible, would purchase at a price in excess of the redemption price.

It would appear to me, however, that there may be a number of reasons for a reasonable investor purchasing at a cost in excess of the redemption price knowing full well EDISON's beliefs and intent, e.g., the investor might believe EDISON incapable of issuing common stock. Be that as it may, if the premise is accepted, a solid argument for scienter can be constructed since at some point, EDISON had to know that the market was unaware of EDISON's belief in its right to redeem and intent to do so when feasible.

Once this knowledge was in EDISON's hands, subsequent purchasers of the STOCK could seek to establish liability based on

reckless failure to disclose material information. Further, the original purchasers could benefit from the argument that although scienter was absent at the time of issue, in light of the subsequently acquired knowledge, nondisclosure might indicate development of a scheme to defraud.

The answer to both theories is the same. Although the original prospectus may have failed to adequately disclose EDISON's belief and intentions, a question I expressly reserved earlier, there are subsequent disclosures here, the February 25, 1971, proxy statement and the statements made at the annual meeting and contained in EDISON's Report of Annual Meeting. If those statements adequately disclose defendant's beliefs and intentions, there can be no recovery on either of these theories.[10] As Justice White said:

> . . . the Court repeatedly has described the "fundamental purpose" of the Act as implementing a "philosophy of full disclosure"; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.[11]

The pertinent portions of the proxy statement and the report of the annual meeting have been quoted earlier. *See*, pp. 6-7, *supra*. (App. p. A-10) The statements of EDISON in those documents clearly reveal EDISON's belief in its right to redeem and its intent to do so when market conditions made such a redemp-

[10] Plaintiffs emphasize that the redemption was in reckless disregard for the rights of its shareholders. The rights of the shareholders under the redemption provision appears to me to be a question of contract and will be discussed in Part III infra. Further, this theory does not appear to place the charged omissions and the necessary mental state in the same time frame. Suffice to say, if there was adequate disclosure of the omissions asserted, a 10b-5 action premised on the redemption itself will not lie.

[11] Santa Fe Industries, Inc., supra n. 3 at 477-78.

tion feasible. The only question is the adequacy of the disclosure.[12]

Defendant's witness Jerry Quilty testified that all of defendant's 190,000 shareholders, including both individuals and institutions, received a copy of the February 25, 1971, proxy statement. Mr. Quilty also testified that each shareholder and 1,134 analysts and brokers received copies of the report of the 1971 annual meeting. Further, Mr. Quilty testified that both the proxy statement and the report of the annual meeting were circulated to a media list containing 260 newspapers and other public information services including the Wall Street Journal, the New York Times, and the Associated Press Wire Service.

Other testimony from plaintiffs' own witnesses establishes that defendant's belief and intent were broadly disseminated prior to redemption. Both Mr. Lobb and Mr. Pruitt of Texas Teachers testified that Texas Teachers had information from the market place and from the brokerage house of Merrill Lynch, Pearce, Fenner & Smith, that defendant might redeem the stock. Mr. Parker, of the Duff & Phelps firm, also testified that he had heard information in the market place pertaining to the statement contained in defendant's proxy statement and the report of its annual meeting.

Under these circumstances the evidence establishes that there was adequate disclosure of defendant's belief that it could legally redeem and of its intention to redeem when market conditions made it feasible through the February 25 proxy statement and the 1971 report of its annual meeting. Those disclosures thwart any claims based on a breach on the continuing duty to disclose material information, and provide no evidentiary support for the asserted scheme to defraud.

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[12] This question recurs in plaintiffs' third party beneficiary theory and is discussed again in Part III. A. infra.

The evidence fails to support any finding of liability on any of the claims asserted under Rule 10b-5. Therefore in accord with the analysis above, judgment must be for defendant and against plaintiffs on all the federal securities claims.

III

Along with theories asserting securities law violations, plaintiffs have two pendant claims based on breach of contract. Plaintiffs' first theory is that they are third party beneficiaries of a contract, the New York Stock Exchange listing agreement, between defendant and the New York Stock Exchange. Plaintiffs' second theory is that the redemption provision constituted a contract between EDISON and its stockholders and that the redemption violated that contract since it was ". . . directly, indirectly, by or in anticipation of debt." Each of these theories of liability will be discussed more fully below.

A. NYSE LISTING AGREEMENT

In order for a stock to be listed on the New York Stock Exchange, the issuer must enter into a "listing agreement" with the Exchange. Although the agreement in this instance has not been produced, it must be assumed that such an agreement was executed since it is undisputed that the STOCK was listed on the New York Stock Exchange.

The listing agreement is said to be not only for the benefit of the parties—EDISON and the Exchange—but also specifically for the benefit of the investing public. Plaintiffs claim therefore that since the benefits accruing to the investing public were specifically contemplated by the parties to the agreement, damages may flow to plaintiffs as third party beneficiaries for any breach of that agreement. The breach asserted is that the publication surrounding the 1971 proxy statement and the 1971 annual meeting was insufficient under the listing agreement.

Although the evidence fails to support a finding of any "plan" to redeem as of April 2, 1977—as opposed to the clearly established intent to redeem "when market conditions made it feasible"—plaintiffs allege that the increase in the number of authorized shares of common stock was corporate action which "looked toward" redemption. The increase in the number of authorized shares of common was proposed in the proxy statement of February 25, 1971, and approved at the April 1971 annual meeting.

Plaintiffs argue that under Section A10 of the New York Stock Exchange Company Manual,[13] a general news release[14]

> . . . shall be made as soon as possible after corporate action which will lead to, or which looks toward, redemption is taken. *Van Gemert, supra* n. 13 at 1376.

Thus, plaintiffs reason that the increase in the authorized shares of common stock was a corporate action "looking toward" redemption and that defendant failed to issue a general news release.

In *Van Gemert,* plaintiffs were a class of debenture holders who held the right to convert the debentures to common stock prior to redemption. Members of the class failed to convert their debentures to common stock assertedly because of inadequate notice of the redemption.

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[13] It should be noted that neither the NYSE Company Manual nor the listing agreement which the Manual is purported to interpret are before the Court. But by stipulation of counsel, the pertinent provisions of both, as found in Van Gemert v. Boeing, 520 F.2d 1373 (2nd Cir. 1975) cert. den. 423 U.S. 947 (1975), on damages 553 F.2d 812 (2nd Cir. 1977), are applicable to the case at bar.

[14] Defined as a release to:

> One or more newspapers of general circulation in New York City, which regularly publish financial news, or to one or more of the national wires services (Associated Press, United Press International), in addition to such other release as the company may elect to make. Van Gemert, supra, n. 13, at 1376-1377.

Plaintiffs here advance two theories which were also asserted by the plaintiffs in *Van Gemert.* Plaintiffs assert that they were third party beneficiaries under the NYSE listing agreement and that the terms under which the defendants accomplished redemption constituted a contract of adhesion which should not be enforced.[15]

Although the author of the *Van Gemert* opinion, Circuit Judge Oakes, indicated that he would base his finding of liability on the third party beneficiary theory,[16] the majority of the panel found defendant's liability arose from a failure to provide debenture holders with fair and reasonable notice of redemption and failure to adequately apprise the debenture holders of what notice of redemption they could expect.[17] The majority found that the duty to adequately apprise the debenture holders of the manner in which a notice of redemption could be expected arose out of the "contract between Boeing and the debenture holders, pursuant to which Boeing was exercising its right to redeem the debentures."[18]

While I, like Judge Oakes in *Van Gemert,* find the listing agreement theory attractive, there are a number of hurdles which plaintiffs fail to overcome.

In order to establish EDISON's liability on this theory, I believe plaintiffs must establish that: (1) the listing agreement vests third party beneficiary rights in plaintiffs; (2) that Section A10 is incorporated into the listing agreement; (3) that the "looking toward" language of Section A10 requires a general press release in the case of the type of tentative corporate action taken here; and (4) that such a release was not made.

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[15] This latter theory is discussed in more detail infra.

[16] See, 520 F.2d 1373, 1382 n. 19.

[17] Id. at 1383-1386.

[18] Id. at 1383.

Although a number of the links in this chain are weak, I believe that the fourth link—the showing that such a release was not made—is missing entirely.

The testimony of Mr. Quilty, discussed earlier,[19] is uncontroverted and establishes that a general news release was made. The fact that the release contained other corporate data and was not shown to have actually been published would not appear to constitute a breach of the requirements of Section A10.

B. BREACH OF SHAREHOLDERS CONTRACT

The final question presented is the very heart of the litigation. Plaintiffs argue that EDISON, in violation of its contract with plaintiffs, "redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt" at an interest cost of less than 9.44%.

It is unquestioned that the redemption terms of preferred stock issues create a contract between the corporation and its stockholders. See, *Tennant v. Epstein,* 356 Ill. 26, 33 (1934); *Kern v. Chicago & Eastern RR Co.,* 6 Ill. App. 3d 247, 250 (1st Dist. 1972); and 11 *Fletcher Cyc Corp.* (per. ed.), ch. 58, §§ 5295, 5309 (1971 revised volume). Further, there is no dispute surrounding the relevant facts. EDISON redeemed the STOCK directly out of an issue of common stock and warrants at a time when its need for financing, to continue the construction program, was apparent. It is undisputed that the needed funds were available at an interest cost of less than 9.44%.

The question presented is purely one of contract construction. Does the "directly or indirectly, by or in anticipation" language permit redemption out of the proceeds of an issue of common

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[19] See, pages 17-18, supra. (App. p. A-20)

stock and warrants regardless of EDISON's borrowing projections?

The first step in the construction of any contract is to examine and interpret the language. The redemption provision is quoted in full on pages 4-5, *supra.* (App. p. A-8) The key provision provides that prior to August 1, 1980, none of the STOCK:

> . . . may be redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt or the issuance of any shares of the Prior Preferred Stock or any other stock ranking prior to or on a parity with the Prior Preferred Stock, if such debt had an interest cost to the Company (as defined) or such shares have a dividend cost to the Company (as defined), less than the dividend cost to the Company of the 9.44% Prior Preferred Stock.

Each of the parties has presented a number of principles of contract construction urged as controlling under the circumstances. Each will be examined below. But it should be noted that the general goal of the contract construction—determining the intent of the parties and giving it effect—is difficult to achieve here because the contract was not one formed through negotiations between two parties. EDISON drafted the provisions and offered the stock for sale to the general public. There was no contact between the parties concerning the terms of the redemption provision, although there were negotiations between EDISON and its principal underwriter, First Boston Corporation concerning the redemption provisions.

In any event, the evidence shows that from the beginning, EDISON believed that the redemption provisions gave it the right to redeem out of the proceeds of an issue of common stock at any time. On the other hand, the evidence also establishes that a number of the members of the plaintiff class including the class representatives, believed that EDISON had

no right, under the redemption provision, to redeem in any manner so long as EDISON could foresee that money would have to be borrowed at an interest cost of less than 9.44% for its construction program.

EDISON makes a number of agruments in support of its position. First, that the clear meaning of the provision allows the actions taken here. The argument is based on the use of the word "refunding". Since the redemption provision provides that none of the stock:

> . . . may be redeemed through *refunding* directly, indirectly, by or in anticipation of any debt . . . (Emphasis added.)

and since common stock is part of the permanent capital of the corporation and cannot be refunded, refunding through an issue of common stock is permissible. EDISON argues that a redemption directly out of an issue of common stock cannot be indirectly by or in anticipation of debt since the refunding operation necessarily must terminate with the issue of common.

This argument does not take into account the broad reading of "anticipation" argued for by plaintiffs. They read "anticipation" as an ordinary word used in its ordinary sense. There is no technical use in the trade meaning for anticipation, they assert. The generally accepted meaning of anticipate is the equivalent of forecast or foresee. Thus plaintiffs argue that the redemption terms forbid redemption even out of common stock, at a time when EDISON forecast borrowing money at an interest rate of less than 9.44%, the precise factual situation here.

Were it not for "refunding", plaintiffs' argument would be persuasive. However, there appears to me to be a logical distinction between redemption in anticipation of debt and redemption through refunding in anticipation of debt.

The actions of EDISON as shown by the evidence, could be characterized as redemption in anticipation of debt since it well knew its financing needs and that in the current market those needs could be met at a cost of less than 9.44%. If the redemption clause requires an examination of the entire borrowing activities of EDISON then plaintiffs should prevail.

However, I believe that the clause forbidding redemption through refunding by or in anticipation of debt, requires an examination of only the source of the funds actually used to achieve the redemption. Were the proceeds of the issue of common stock and warrants in anticipation of debt at an interest cost of less than 9.44%? The answer must be no. Common stock cannot be refunded.

The concepts are illusive but perhaps the interpretations of plaintiffs and defendant can be contrasted with a simple example. Were a man to borrow $1,000 from the bank in order to start a small business, the bank might well place a provision in the loan agreement forbidding the borrower from repaying the $1,000 from funds derived in any manner out of the funds borrowed at a lower interest rate.

Plaintiffs would argue that this agreement would preclude the borrower from taking on a partner for $1,000 and using that $1,000 to repay the bank loan when the borrower knew that within a short period of time the borrower and his new partner were going to borrow $20,000 for expansion of the business. EDISON on the other hand would contend that so long as the $1,000 used to repay the bank was in no way derived from funds borrowed at a lower interest rate the plans of the partnership for expansion are irrelevant. The question would be whether the agreement controlled the source of the funds used to repay the loan or the borrowing activities of the borrower entirely. Certainly the borrower in the example could repay out of the proceeds of a sale of a ½ interest in the business and still be planning to borrow $20,000 to buy himself a yacht.

In each case the borrower anticipates borrowing funds. But in neither case does he anticipate borrowing funds to replace the capital advanced by the bank. If he anticipates borrowing to buy himself a yacht, clearly the $1,000 is in no way affected. And likewise, although it can be argued that he would have been wiser to save the $1,000 invested by his new partner and thus borrow only $19,000 for business expansion, the $1,000 used to repay the bank has no real connection with his expansion plans. He did not agree to remain in debt to the bank as long as he was going to be in debt to anyone. He merely promised to repay the borrowed funds out of capital derived in a manner other than through new debt.

The question in this case is the same. Does the redemption provision control the source of the funds used to supply the $110 million necessary for redemption or does it forbid redemption so long as it could be foreseen that funds would have to be borrowed to complete EDISON's construction plans? Unless the provision seeks to control only the source of the repayment fund, the word refunding has no meaning.

When the word refunding is given meaning, the question of borrowing by or in anticipation of debt is narrowed from corporate borrowings in general, to the funds and the methodology used to replace the $100 million dollars raised by the preferred stock issue. Thus, whether the corporation as a whole was "in anticipation of debt" is not the issue. The question is whether the redemption itself, was in anticipation of debt. Where did the money used to redeem the preferred stock come from and was that source in anticipation of debt?

This is the only construction which gives meaning to both the words, "redeem" and "refunding". Plaintiffs use redeem and refund interchangeably. But there is a difference between redemption by or in anticipation of debt and "redeem *through refunding* by or in anticipation of debt".

This interpretation is bolstered by two other provisions of the prospectus. On page 1 of the prospectus, it is provided that the STOCK is not redeemable prior to August 1, 1980, directly or indirectly "through certain refunding operations." Further, in the redemption clause itself, $110 ($10 premium over purchase price) is set as the redemption price if redeemed prior to August 1, 1980.

These provisions can only be interpreted as showing that EDISON considered redemption a real possibility. They further show that the language is intended to restrict the scope of the "refunding operations" and only by limiting refunding operations, place limits on redemption. The method used to redeem cannot be in anticipation of debt but the corporation itself may be, under the language. Use of the words "refunding operation" points up the difference between "refund" and "redeem".

The interpretation plaintiffs seek would allow redemption prior to 1980 only in two very unlikely circumstances: out of funds with an interest cost in excess of 9.44% or out of any fund so long as the construction plans were scrapped and no funds were to be borrowed. Given economic reality, no corporation is going to redeem out of higher cost debt. Neither is it likely that a corporation, whose main enterprise is the production of electric power, will cease proposed construction and expansion. Given today's ever increasing demand for electrical power, ever greater construction and expansion can be expected.

Thus, plaintiffs' interpretation in effect would render the stock uncallable prior to August 1, 1980. If this were EDISON's intent it could have been achieved with a great deal less words. Further, it is not beyond the realm of speculation that a stock issued as uncallable for ten years could have been sold bearing a lesser rate of return than 9.44%.

In the construction of a contract an interpretation which gives reasonable meaning to all its terms is preferred to an interpretation which leaves some terms to no effect. *See, Thomas Hoist Co. v. Newman Co.*, 365 Ill. 160, 166 (1937); *Restatement of Contracts*, § 236(a); *and Williston*, Contracts § 619, p. 731 (3rd Ed. 1971). The interpretation sought by plaintiffs would render meager meaning to the price for redemption prior to August 1, 1980 and no meaning to the word "refunding." The objection to EDISON's interpretation is that it does not give "anticipation" the broadest possible meaning. Under these circumstances, EDISON's interpretation must prevail.

Having reached that conclusion the remaining discussion is perhaps unwarranted but in view of the time and effort expended by the parties and their counsel and in view of the length of the opinion at this point, I would feel remiss if some mention of the other arguments were not made.

EDISON argued further, that in the event the redemption terms were found ambiguous, trade usage should be used to interpret those terms. In this regard, EDISON offered the expert testimony of Mr. Edward Lebens of the First Boston Corporation, Mr. Sanford Reis of Reis & Chandler, Inc., and Mr. Fergus McDiarmid of Lincoln National Life Insurance Company. Mr. Lebens, as discussed earlier, testified that the language here in question grew out of investor responses to corporate bond rollovers occurring in the 1930's and 40's. All three of plaintiffs' witnesses testified that the language here was never intended to prevent redemption out of common stock and that since common stock was the company's permanent capital it was never issued in anticipation of any further financial activity.

Although the veracity of these witnesses is undoubted, this evidence is unpersuasive. The problem with the evidence is determining what "trade" is familiar with these terms and their

history. None of the plaintiffs who testified, nor any of plaintiffs' employees, were aware of this trade usage or the history surrounding it. The credentials of many of plaintiffs' witnesses are unsurpassed. Apparently one must have been active in the bond market of the 1930's and 40's to be aware of this trade usage. Further, were the redemption provisions contained in a corporate bond, the expert testimony would be more relevant and more persuasive. But the issue here is preferred stock. The exhibits establish that similar language is not uncommon in preferred stock issues. But the evidence fails to establish that the language had a generally known or well established trade usage among those commonly dealing with preferred stock issues.

Plaintiffs' major argument on the contract issue is that the redemption terms constitute a contract of adhesion and thus any ambiguities must be construed against the drafter. It is generally stated that where there is a standardized contract made between parties of disparate bargaining power, the unconscionable features of that contract are unenforceable as a manner of policy. *Van Gemert, supra.* n. 13 at 1380. *See also, Kessler, Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629 (1943).

Here, there are a number of factors which I believe make the adhesion contract idea unworkable. Primarily, this is because the provisions of the redemption terms as interpreted by EDISON, are not unconscionable. The question here is not whether those terms are unconscionable but which of two interpretations of the language is to be given effect.

While the adhesion contract theory is inapplicable, I believe its corollary—*Contra Proferentum*—could be appropriate for application here. *Contra Proferentum* is a rule of contract interpretation which provides that when the words of a contract have been chosen by one party and another merely assents to those

words, that fact alone may tip the balance against the party drafting the contract. As noted earlier, that fact situation is present here.

EDISON makes the point, and I believe it well taken, that the idea of construing a contract against the drafter is not a result oriented rule but rather a rule which provides an answer when all other methods of construction and interpretation still leave the contract ambiguous. *Contra Proferentum* is to be used to ascertain meaning where ambiguities remain and not to achieve a verdict for the nondrafter of the agreement. *See, Hurd v. Illinois Bell Telephone Co.*, 136 F.Supp. 125 (N.D.Ill. 1955), *aff'd* 234 F.2d 942 (7th Cir. 1956); *Bowler v. Metropolitan Sanitary District of Greater Chicago*, 117 Ill.App. 2d 237 (1st Dist. 1969), *and* 3 *Corbin on Contracts*, § 559 (1964).

Here the rule of interpretation which requires all the terms of the contract to be given meaning establishes the controlling interpretation to be given the redemption terms. There remains no ambiguity to be construed against the drafter.

Although I believe EDISON could have avoided this entire matter by making its right express, I cannot say that EDISON's drafting, which stated expressly the methods by which redemption was prohibited and impliedly reserved to itself all other methods, violated the Federal Securities Laws or violated plaintiffs' vested contract rights. The decision here has not been quick nor easy. Drafting could have alleviated not only the time and effort spent here but the unrewarded expectations of plaintiffs.

Judgment for defendant on all Counts.

Enter this 19 day of May, 1978.

J. WALDO ACKERMAN
United States District Judge

APPENDIX E

Statutes and Rule

The pertinent portions of the Securities Act of 1933 are:

Section 11, 15 U.S.C. § 77k:

"(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such aquisition he knew of such untruth or omission) may; either at law or in equity, in any court of competent jurisdiction, sue— * * *"

Section 17, 15 U.S.C. § 77q:

"(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. * * *"

The pertinent portions of the Securities Exchange Act of 1934 are:

Section 15 U.S.C., Section 78j(b):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R., Section 240 10b5:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-242

THE FRANKLIN LIFE INSURANCE COMPANY, A CORPORATION, INDIVIDUALLY AND REPRESENTATIVELY ON BEHALF OF ALL HOLDERS OF THE 9.44% CUMULATIVE PRIOR PREFERRED STOCK OF COMMONWEALTH EDISON COMPANY, A CORPORATION, *Petitioners,*

vs.

COMMONWEALTH EDISON COMPANY, A CORPORATION, *Respondent.*

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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Petitioners,

vs.

COMMONWEALTH EDISON COMPANY, A CORPORATION,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

The respondent, Commonwealth Edison Company ("Edison"), an Illinois public utility, respectfully requests that this Court deny the petition for a writ of certiorari seeking review of the decision of the Court of Appeals for the Seventh Circuit.

OPINIONS BELOW.

The *per curiam* opinion of the Court of Appeals, adopting the District Court's memorandum opinion, and the memorandum opinion itself are reproduced in the appendix to the petition.*

* Reference to those opinions will be made to the petition as "App. ...."

STATEMENT OF THE CASE.

This case concerns preferred shares of Edison stock (the "stock") sold by Edison at $100 per share in 1970 and redeemed by it at $110 per share in 1972. The gist of petitioner's suit is that Edison, under the terms of the stock issuance, did not have the right to redeem the stock in 1972, and therefore, that the redemption violated petitioner's common law contract rights and federal securities laws rights.

The argument which follows is essentially that the case did not, and cannot, turn on the questions raised now in the petition. For that reason, and because respondent's argument is brief, we do not attempt to restate the questions presented by petitioner. Instead, the questions actually decided by the District Court, along with some facts not contained in petitioner's statement of the case, are recited in the body of the argument.

REASONS FOR DENYING THE WRIT.

This is an action for an alleged breach of contract. Because the contract was for the purchase of a security, the suit, like many others in recent years, was filed in a federal court, claiming that the alleged breach was also a fraud under the securities laws.

The District Court found no breach and no securities fraud. The decision was affirmed *per curiam* by the Court of Appeals.

The case involves no conflict among circuits, nor novel interpretations of law. The federal questions which petitioner claims are raised, while perhaps interesting, were not decided below. They were not decided because the trial court, as to each question, assumed that the law was as the petitioner claimed, and then found that even under petitioner's theories the facts did not support liability. The two decisions below thus turned on findings of fact regarding the defendant's state of mind and the scope of the dissemination of certain information to the

public. As a result, the judgment can be reversed only by upsetting the trial court's findings of fact, as concurred in by the Court of Appeals, a result rarely achieved under the "two court rule". *Graver Tank & Mfg. Co.* v. *Linde Co.*, 336 U. S. 271, 275 (1949); *Berenyi* v. *Immigration Director*, 385 U. S. 630, 635 (1967).

The Petition suggests three federal legal issues as a basis for granting the writ: (1) the scope of the disclosure obligation imposed by the 1933 Act as it applies to the redemption terms of preferred stock; (2) the scope of the scienter standard established in *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976); and (3) whether a redemption is a "sale" for purposes of Section 10 of the 1934 Act or Section 17 of the 1933 Act. (Pet. at 12-13.) As a fourth basis, petitioner suggests review is in order simply because a large sum of money is involved (Pet. at 13.)

In fact, none of the bases—legal or monetary—are presented by the decisions below.

A. Economic Issue.

Petitioner's basic theory, in both the securities and contract branches of the case, was that Edison, like all large electric utilities, would be borrowing substantial amounts of money over the period from 1970 to 1980 to pay for new generating units. From the fact that Edison, as a "net borrower" over this period, knew that it would be selling new debt, petitioner surmised that Edison would therefore always be "in anticipation of the incurring of any debt . . ." as that phrase was used in the restriction on refunding. Thus Edison would never be able to redeem the stock. The problem, as the record below shows, was that petitioner confused economic reality with legal requirement. The actual effect of the large construction budgets was that most utilities needed every cent they could raise to pay their debts, and could not allocate newly raised funds to non-

operating purposes such as the redemption of earlier securities. Edison, for a time in 1972, happened to be able to afford that luxury. Its redemption, therefore, disappointed petitioner's economic expectation; that disappointment was then converted to a claim of legal wrong.

The record below included testimony regarding a large number of issues of utility preferred stock. That testimony (embodied in the District Court's opinion at App. 17 but not set out as detailed findings of fact) was that preferred stock is issued with a variety of terms relating to its redemption. Some allow redemption without restriction; some expressly prohibit redemption by saying that they are "not callable"; and some fall between those extremes. (Tr. 558-561.) That middle ground is itself of some width, and includes a variety of restrictions, both as to sources of funds that can or cannot be used, and as to the length of time and penalty price to be paid during the term of the restriction. (Tr. 561-563).

Nine of the preferred stock issues considered below contained no restrictions at all on redemption. All nine of those stocks were still outstanding at the time of trial in 1977. (Tr. 558-559.) The reason they are still out, as the testimony below established, was that redemption depends on the economic facts facing each company. Even without legal restrictions, preferred can be redeemed only if a company can afford to spend its funds to do so. In Edison's case, its 1970 preferred shares could be redeemed only if it could afford to sell common stock for that purpose. (Tr. 602-603.) While it is outside the record in this case, the price at which Edison can sell common shares is no longer above the book value of those shares. The same fact is true of almost all utilities.

While the case involves a fairly large sum, and other preferred issues of substantial size are in the hands of investors, the record below shows that this case will not decide the fate of other issues of preferred stock. The trial judge exercised care to confine his holdings to determinations on the facts of this

case. There is no holding suggesting a new or different standard for future financings. Additionally, petitioner's own argument has emphasized that Edison's redemption language, although "similar to that of other utilities," was used by no other utility. (Pet. at 22.) While some other utilities do in fact use this language, the record below reflects the large number of variants in use. The trial court's interpretation of particular language is scant cause to fear mass utility redemptions of preferred stock. The likelihood that any utility will be redeeming preferred shares, no matter what happens to this case, thus appears to be quite small.

The record thus tends to show that the risk which is said to justify granting certiorari here, that some billions of dollars of preferred shares will be redeemed if this case were affirmed, is a risk which can safely be left to the distinct economic and legal restrictions which were bargained into other issues of preferred shares.

B. Legal Issues.

The legal questions which petitioner seeks to raise are not presented by the opinions below.

The first legal issue raised by petitioner is whether the prospectus adequately described the redemption terms of the preferred shares. However, this is an issue that was not decided below because the case was disposed of on other grounds. The trial court reasoned that:

> Further, whether the language of the prospectus adequately disclosed these facts is another question on which I express no opinion.
>
> Assuming however, that the securities laws require this type of disclosure and that the prospectus did not adequately discloses these facts, the question remains whether the non-disclosure was done intentionally or recklessly or as part of a scheme or artifice to defraud. (App. 16.)

Issues which the trial court has expressly reserved as unnecessary to the decision are not proper basis for granting a writ of certiorari.

Petitioner's second legal issue is whether the court properly interpreted the scienter requirement of *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976), especially in light of petitioner's contention that recklessness may be sufficient basis for liability. The short answer to petitioner's question is that the trial judge ruled that petitioner had proven neither scienter nor recklessness in its case. (App. at 17.) No facts were found which could support liability under either standard. Petitioner's scienter issue is nonexistent.

Petitioner's final legal argument for granting the writ is that the antifraud provisions of the 1933 and 1934 Acts ought to apply to a redemption. The trial court did, however, "apply" the relevant antifraud provisions of those statutes to the redemption. (App. at 17-21.) The trial court went so far as to assume that there could be liability under Rule 10b-5, despite a wholly accurate registration statement, if Edison failed to timely inform the market of its intention to redeem. Under this most favorable interpretation of law for petitioner, the Court found that Edison had informed the market in a timely and adequate way, by sending proxy materials and a report of what occurred at its annual meeting to 190,000 shareholders, 1,134 brokers and analysts, and 260 newspapers. (App. at 20.) We do not know how to phrase a legal position more favorable to the petitioner than that applied by the trial court's analysis.

In sum, the legal issues on which petitioner seeks to justify its petition are simply not part of the controversy resolved below and, therefore, merit no consideration here.

C. Other Issues.

The petition also attempts to raise two common law contract questions. The first issue is whether Edison breached any contract it had with purchasers of the shares. The second is

whether Edison breached any contract it had with the New York Stock Exchange as to which some purchasers of the stock may have been third-party beneficiaries.

The common law principles of contract law which apply to each of these issues are well settled and apparently uncontested in the petition. Thus, there is no need for review of these matters by this Court.

The petition actually seeks a *de novo* review of the essentially factual determinations made by the trial court. Such a review is, of course, contrary to the generally applicable standard that factual determinations will be reversed only if clearly erroneous. *Roemer* v. *Maryland Public Works Bd.*, 426 U. S. 736, 758 (1976).

More importantly, in the absence of exceptional circumstances, mere factual questions are not proper objects of this Court's discretionary review powers. Petitioner points to no overriding consideration of public policy or issue of national import which would justify this Court injecting itself into essentially factual questions that have been thoroughly heard and identically decided by two separate tribunals.

CONCLUSION.

Petitioner has presented nothing to this Court which either generally conforms to the guidelines for granting certiorari set forth in Supreme Court Rule 19 or which otherwise demonstrates sufficient merit to require decision by this Court. The legal issues raised are not, in fact, in controversy here. Petitioner really seeks only a third chance to argue factual theories already twice rejected. For these reasons, the petition should be denied.

Respectfully submitted,

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